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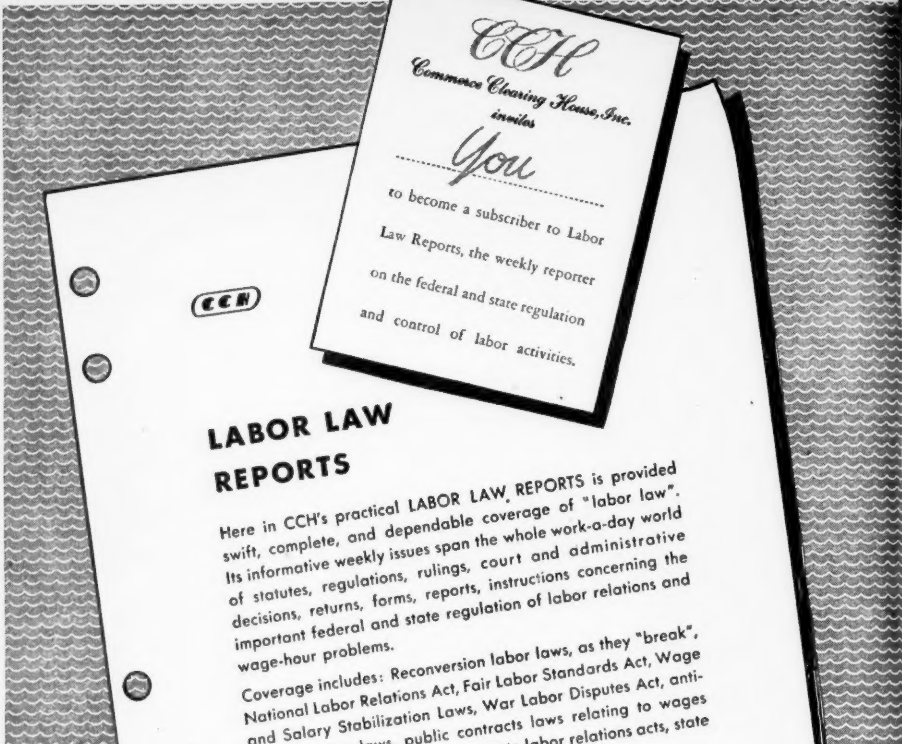
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VOL. XV *November • 1945* NO. 11

Recent Developments In Accounting Principles

By JAMES L. DOHR, C.P.A.

This is an address which was given at the monthly meeting of the Society at the Waldorf-Astoria Hotel on October 8th, 1945.

I AM particularly gratified to accept the invitation on this occasion to appear before the New York State Society of Certified Public Accountants because of the subject-matter which has been assigned to me: that of Current Developments in the Formulation of Generally Accepted Accounting Principles. It is a subject-matter which I think is of supreme importance to everyone who has an interest in the profession of accounting.

JAMES L. DOHR, C.P.A., is a certified public accountant of Wisconsin and Michigan, and is a member of the New York Bar. He has been teaching for a number of years in the School of Business at Columbia University and he is a member of the law firm of Greene and Greene. He holds the degrees of B.A. from the University of Wisconsin, B.S. from Columbia University and LL.B. from Columbia Law School. He has been a member of the American Institute of Accountants since 1919 and has served on its staff as Director of Research. He has been Chairman of its Committee on Publications and a member of the Committees on Accounting Procedure and Terminology. Mr. Dohr is the author of "The Law Business", "Cost Accounting", and "Lecture Notes on the Law of Accounting".

In order that you may understand what I have to say, my remarks are based principally upon my participation, as a member, in the work of the Committee on Accounting Procedure of the American Institute of Accountants, plus a very profitable period of three years when I acted as its Director of Research. Mr. Carey will bear witness to the fact that I was paid for performing that service; as a matter of fact, I should have paid tuition to the American Institute of Accountants for the education it gave me during that three-year period.

I begin by referring to your audit certificate, in which you state or indicate that the financial statements are prepared in accordance with generally accepted accounting principles. If, in any respect, the statement is not so prepared, you take an exception. To the average reader of your certificate, that language would convey, I think, the existence of a complete and comprehensive body of accounting rules which were applied by you as a preliminary

to your certification. We know that such is not the case.

While accounting is old, the accounting profession is a young profession, very largely in a process of development. There is much difference of opinion as to what should be generally accepted accounting principles and, while much has been done, much remains to be done.

I think it fair to say that, in many respects, your certificate means no more than that there is some authoritative support for the principles which have been applied in the preparation of the statements.

I should like to divide my remarks into two parts. Before coming specifically to the matter of Current Developments in Generally Accepted Accounting Principles, I think it is important that we have an adequate realization of the background, if you please—or perhaps the state of mind—with which the problem should be approached. And in a sense I do not apologize for that preliminary, because I think if the problem is approached with the proper state of mind there will be no question as to the outcome.

The first factor in this background is a realization that we live in an ever-changing economy and that accounting principles must be attuned to current social, economic and political developments. This is not to say for a moment that we should change our position with every "change in the wind"; on the contrary I think we will best serve our economy by maintaining a very high degree of stability. It does mean, however, that on occasion we must examine our life-long convictions and we must be prepared, under proper circumstances, to surrender those convictions. Accounting is no place for a man without an open mind.

The second factor is an adequate realization of the plain fact that accounting is complex. Accounting functions in an economy which is highly complicated. It was not so very long ago, in terms of years as I know them, that an auditor was commonly defined as "a bookkeeper out of a job". And whatever may have been the merits of that definition, it was true, thirty years ago, that a young man with a couple of text-books and six or eight months of study could obtain a working knowledge of accounting. That is manifestly no longer true, and I submit that accounting today is quite as complex as medicine, law, engineering or any of the other professions. Any man who thinks otherwise does not understand accounting.

The third factor is an adequate realization of the fact that accounting involves the exercise of judgment. Human nature craves formulae and rules with which to solve its problems. That, in the last analysis, explains the success of the patent medicine industry. Whenever a problem arises we instinctively would like to have a formula or a rule which would solve our difficulties. I submit that accounting can never be wholly a matter of formulae and rules. To put it another way, every rule which we can develop as accountants must be subject to the over-riding requirement that there is no substitute for, and no escape from, the exercise of judgment under all of the surrounding circumstances. The man who is disinclined to exercise his judgment should not be an accountant.

The fourth factor is an adequate realization of the fact that accounting involves approximations. It is not an exact science. Moreover, I am inclined to the view that it isn't a science at all but rather an art. Science has as its objective knowledge, whereas art has as its objective, works; and if there is anything in which we are entitled to take pride it is the fact that our profession is one that "works". Again, human nature craves certainty. I have been told that young men study accounting because it is a field in which they can get a "correct" answer. I should be the last in the world to disparage mathematical accuracy, but even in your accounting for cash you must never forget

that the dollar is a varying standard of measurement. It is extremely unfortunate, I think, that the layman has gotten the idea that accounts can be correct or otherwise; and his belief in that respect is strengthened by the practice sometimes indulged in of issuing preliminary or estimated statements which are to be followed by a formal or definitive statement. He doesn't know—the layman—that even the formal or definitive statement is to a very large extent a matter of estimate, approximation and convention. The man who wants mathematical accuracy should be either a surveyor or a bank teller and not an accountant.

The fifth factor is an adequate realization of the importance of what I call "honesty of representation". Accounting is characterized by the fact that it provides information which is acted upon by people who are not accountants. There was a time in our history when men might speak or be silent, as they choose, and when they were required to be truthful only insofar as they uttered. The situation today is radically different. The financial statements are representations of fact and opinion on the part of the company and other auditors, and honesty in representation today requires that the representations be not only truthful but that they also be complete and not misleading, under all circumstances.

This, I think, gives rise to the broadest responsibility on the part of accountants, and after you have applied all the rules in the book you should stop to ask yourselves whether what you are saying is truthful, complete and not misleading under all of the circumstances; and while it may not be germane to the subject-matter of my discussion I would like to say that that same standard of honesty of representation should be applied to people who use accounting data.

In connection with this matter of honesty of representation, the fact of critical importance is the effect of your language upon the person to whom your representation is addressed. That of course brings us to the question of accounting terminology, which is a subject-matter for another evening. But I would like to observe the necessity on your part of a constant regard, not to your own understanding of the meaning of words, but to the understanding of your listeners as to the meaning of words.

In the recent report of the labor unions on profits in the steel industry, the unions refer to "open" and "concealed" profits. One of the items of concealed profits is a part of the reserve for depreciation; and to illustrate my point, I regard the term "reserve for depreciation" as one of the most unfortunate we have ever used. We knew what we meant by it, but the nontechnical reader, given a reserve for depreciation on the right-hand side of the balance sheet, could, in the last analysis, scarcely be blamed for referring to it as concealed profits.

The sixth factor is an adequate realization of your basic objective. When I started the study of accounting, the balance sheet was of paramount importance. That was easily understandable because we believed, I think, that the "worth" of an enterprise could be determined by a properly prepared balance sheet. In fact, in those days, we commonly referred to the excess of assets over liabilities as "net worth" or "present worth". We know very well now that the present worth of an enterprise cannot be determined by a properly prepared balance sheet, and our emphasis has shifted to the income statement. We must realize, then, in this problem of formulating generally accepted accounting principles, that the income statement is the statement of outstanding importance.

That leaves us with the necessity of redefining the function of the balance sheet and, without going into the matter at length, I suggest that under a proper view the function of the balance sheet is two-fold: first to indicate the ability of the business enterprise to meet

its obligations as they mature, and secondly as a vehicle by which management accounts for the responsibility it assumes in investing and controlling the funds of the stockholders.

But our basic objective must be broader. We started with accounting as a tool of management, and our basic objective was to help management. As time went on, we learned that we owed a responsibility to investors, and we have done much toward meeting that responsibility; and, whether you like it or not, you are now moving in an era in which your responsibility is even broader. You are coming to be responsible in connection with taxes; in connection with price fixing; in connection with the utility regulation; in connection with labor relations, etc. Instead of acting as a servant of management (and I use the word "servant" in a perfectly proper sense), you have come to be the servant of society; and the man who isn't willing to recognize the broadest kind of social responsibility shouldn't be an accountant.

The last factor that I want to mention requires a decision as to methodology, and like the lawyer you have two options: Under the civil law system of the continent of Europe, law was supposed to be stated in a comprehensive code which would cover all human relations; and there are those who think that we can have an accounting code in the manner of the civil law. The statement of the American Accounting Association is based on that procedure. On the other hand, we have what we call "The Common Law System" of Great Britain and the United States, in which rules are developed largely as a basis for dealing with indicated states of fact.

I think that it is fair to say that for the most part the Committee on Accounting Procedure of the American Institute has elected the common law method. I think that a youthful enthusiasm and a devotion to the principles of logic might indicate an attempt to formulate at one sitting a complete and comprehensive code of accounting. If my experience as Director of Research taught me anything, it taught me the utter impossibility of an adequate solution by that means, and I submit that the methodology to be selected should be one of developing rules largely as applicable to given statements of fact.

That, then, is the background against which generally accepted accounting principles must be developed; and, as I indicated at the outset, I think a decision on your part on these various factors which I have indicated is the most important element in the problem.

Turning now to current developments: The development of generally accepted accounting principles was very much affected by the war. The war gave rise to new problems—and I take it that you are familiar with some of the things that were done on renegotiation, war reserves, accounting for cost-plus-fixed-fee contracts, etc. We now face a further series of war problems in accounting for reconversion and restoration to a peacetime economy.

I have lived long enough to realize that the problems of a war are distinctly transitory. It will be a comparatively short time after the war is ended when these problems will be gone and forgotten. And I would like, therefore, in the limited time which is available to me, to steer clear of the war problems and to refer to those developments which will be effective over a long term. As a matter of fact, I personally subscribe to the belief that in the last analysis none of our war problems were really peculiar; all they required was a somewhat different method of applying the same kind of principles that were applicable in peacetime.

Beginning, then, with the long-term problems, the question of the income statement is manifestly the most important. The Committee issued Accounting Research Bulletin 23 dealing with the presentation of income taxes in the income statement. There has been some criticism of that bulletin,

and I would like nothing better than to deal with those criticisms; however, that, too, is a subject-matter for another evening. Let me simply say that, in the course of preparation, Research Bulletin 23 indicated that there was a clear line of division with respect to the income statement—with respect to its function. There were those on the one hand who took the position that the income statement was in the nature of a prospectus—that it should indicate earning power. The other group took the position that the income statement was a summary of all the income facts occurring within a given period, including facts discovered in that period and corrections of estimates of a prior year.

The difference between those two groups, you will see readily, comes down to the matter of direct debits and credits to surplus. The one group emphasizes the importance which is attached to the single figure of earnings per share and the lack of critical analysis on the part of the reader; to his inability to eliminate extraordinary unusual, non-recurring items. For that reason the one group would permit debits and credits direct to surplus. The other group argues that there must be a consistency and continuity of income statements. They point out, too, the abuses in the matter of debits and credits to surplus, and they suggest that every income item, debit or credit, should appear in the income statement of some year: they prefer the wrong year to no year at all.

I am not so sure that the question is as important as the members of the two groups think. I think that by a campaign of education we can do something about the over-emphasis on the single figure of earnings per share; and I notice that one of the financial services has adopted a practice of reporting the earnings per share and then indicating how much those earnings per share would have been increased or decreased if the extraordinary item had not occurred, attempting to lead the reader to consider the unusual or extraordinary items.

So far as the prospectus is concerned, I wouldn't want to depreciate the use of the prospectus; but, by and large, I suggest that one look at the current income statement is better than a dozen looks at the income statements of prior years. In my own mind it all boils down to a question of honesty of representation. I think you have to make up your mind how you can best prevent misleading inferences on the part of the reader, and I think that you can accomplish your objective in some cases by making direct debits or credits to surplus. In other cases it will be better to have the item in the income statement. The Committee on Accounting Procedure has been engaged on this project for some time, and if you haven't already read it you should read their statement in the September issue of the Journal.

A very practical illustration of the problem arises in connection with the termination of what we are beginning to call the "war venture". Taking the calendar-year companies, it appears reasonable to suppose that the bulk of the reconversion will be over in 1945, and that in 1946 we should begin to get an inkling of what peacetime operations are going to amount to. That being the case, the suggestion has been advanced that, beginning with January 1, 1946 for the calendar-year companies, all items relating to the liquidation of the war venture be excluded from the income statement, to be carried either as debits or credits to surplus.

I have some doubts about the wisdom of such a procedure. We know that in some cases, for instance, war reserves have been established, and that when the war is finally liquidated there will be credit balances in those reserves. Now I am afraid that if we carry those over-reserves to the surplus account we will be accused of having overstated the cost of the war, and we will be put in

an unsound position, at least as a matter of strategy.

There are several other developments which I might refer to briefly in connection with the income statement. Some time ago the Committee decided that the so-called "single-step form of income statement" was at least permissible—that it wasn't necessary to sectionalize to show gross profits, operating profits, gross income, etc. It is too early, at this date, to determine to what extent the single-step form of statement will replace the conventional form.

We have a peculiar problem under consideration at the moment in the matter of stock options. Some years ago we were rather successful, I thought, in our dealing with stock dividends, and by cooperation with the New York Stock Exchange I think we stopped some of the abuses of stock dividends, although, strictly speaking, the matter wasn't entirely one of accounting. I think we have now a similar situation in connection with stock options. We are in a position, by formulating accounting principles on a very broad basis, to stop some of the abuses in connection with stock options. Unfortunately, like so many other matters, there are wide differences of opinion as to how stock options should be treated, and we have not yet been able to get out a bulletin.

Finally, I think that the way for further development can easily be pointed out. The income statement should be so prepared as to permit intelligent study and analysis, and I am not sure but what the cost accountants have not been somewhat more progressive than the financial accountants in this respect. There are a number of ways in which the income statement could be improved to make it a more valuable document to the reader.

Just as a simple illustration, we know very little, I think, about the extent to which costs are shifted to the consumer; and that has come to be a question of paramount importance. The average labor union takes the position that if wages are increased, prices can be increased, and that's all there is to it. What we don't know is the extent to which increases, either in wages, taxes, or anything else, are shifted to the consumer or come out of the hide of the stockholder; and of course there is one fundamental truth which we must not overlook: the strange anomaly that it may be possible to increase costs without any additional charge to the consumer or any diminution of the dividends to the stockholder. I refer, of course, to the possibility of volume output in which the increased cost is offset by an over-all reduction in cost as a result of the increased volume.

Turning to the balance sheet, the outstanding question before the Committee on Accounting Procedure is what we call "the cost and value question". Accountants have long dedicated themselves to the proposition that cost is the controlling factor; and there are very good reasons for the accountants' allegiance to the cost basis. In Bulletin 5 the Committee indicated that fixed assets should normally be accounted for on the basis of cost. In Bulletin 24 the Committee specifically extended that rule to intangibles.

If you will stop to think for a moment you will realize that what we call "cost" is nothing more than market-at-the-date-of-acquisition; so that the problem is not accurately described as one of selecting between cost and market, but rather one of selecting between initial value and some subsequent value.

Where the subsequent value is below cost, we don't have very much difficulty. I take it that generally accepted accounting principles would permit write-downs where cost has been shown to be non-recoverable. We commonly write down in a legal reorganization. And, finally, we are committed to the proposition that, by means of a quasi-reorganization, we may eliminate a deficit and get what we call a fresh start.

It is on the upward side that the difficulty comes, and there are those

who simply say firmly, "We will under no circumstances recognize appreciation". But unfortunately the problem isn't as easy as that, because when you stop to consider, if the stockholders of a given corporation want to reorganize legally, by creating a new corporation, even though the stockholders remain precisely the same, you have no escape from the recognition of present value. If they can do it by means of a legal reorganization, why shouldn't they be permitted to do it without going through the rigmarole of organizing a new corporation? One or the other of those propositions is unsound. If you are not under any circumstances going to recognize appreciation, then you should not recognize it even if they go to the length of organizing a new corporation.

The Committee has under consideration this extremely conservative proposal: That a reorganization—a quasi-reorganization—may be used, even though it results in an upward movement of asset value, provided four conditions are met:

1. That there be positive evidence of the increased value.

2. That all assets and liabilities be comprehensively restated.

3. That any earned surplus in existence at the time of this quasi-reorganization be frozen and not thereafter designated as earned surplus.

4. That the subsequent accounting be consistent with the notion that a fresh start has been put into effect.

That is the extent, I am sure, to which the Committee is willing to go (if it will go that far), and if you have any worries that it will result in a return to the "palmy" days of recognition of flimsy appraisals, etc., I think there is no need to worry. As I understand the proposition, it would be such that a revaluation upward would occur only in a very limited number of cases.

The Committee has under consideration the subject of current assets and liabilities. Accountants conventionally classify as current assets or liabilities those items which will be converted into cash or will have to be met within a period of one year. It is felt that the one-year period is arbitrary; that what we should do is to revise the classification with some regard for the cycle—the short-time cycle—of business operations.

I am not sure that that amounts to very much, because it is my experience that practicing accountants "strong-arm" the one-year rule in order to get substantially the same result. In other words, while we say that one year is the test, I think we have no hesitancy in using a longer or shorter period, depending upon the circumstances.

The Committee got out a bulletin on intangibles—No. 24. The outstanding characteristic of that bulletin was the sanction which it accorded to voluntary write-downs or write-offs of intangibles on the part of management. So far as accounting principles are concerned, intangibles are to be accounted for exactly as tangibles; but the Committee thought that if the management wanted to get rid of its intangibles it might do so voluntarily, and that such procedure could be approved by accountants.

Finally, in connection with the balance sheet, we have the important question of surplus. We have long been committed to a three-way classification of net assets. That classification is as between capital stock, capital surplus, and earned surplus. I think that the classification is most unfortunate and I think we have been more or less "hijacked" into that classification by the lawyers.

The lawyer doesn't care much about the source of capital, and he divides it as between legal capital (that is, his concept of legal capital) and something other than legal capital. In other words, if the stockholders put up $100 a share, by proper procedure the directors say $50 of that amount is legal capital and $50 is capital surplus.

If you will stop to think for a moment, the term "capital surplus" is a

contradiction in terms; "capital" is supposed to represent the amounts that are contributed—"surplus" is supposed to represent what is earned. Capital surplus is neither "fish, flesh nor fowl". The thought on the part of the Committee on Accounting Procedure is that net assets should be divided simply into two parts: accounting capital—which is legal capital plus capital surplus—and earned surplus. That division would be a preliminary to the disposition of a number of vexatious problems which now face us. Let the lawyers keep their concept of legal capital if they want to; to my mind it is largely meaningless. The capital of an enterprise is what was contributed to the management for the purpose of conducting the enterprise, irrespective of what the lawyer may call that contribution. And the only other capital that a corporation can have is that which it has accumulated. Again however, we have a situation where differences of opinion have so far prevented a bulletin on this particular subject.

I think I have now taken a fair amount of your time. I have sketched roughly the current developments, and, in concluding, I would like to turn to what might be called "the commercial", because in connection with these remarks I have an idea that I would like to sell.

You talk about generally accepted accounting principles. What do you mean by "generally accepted"? There are some people who have a very short answer to that question: they say that the way to get generally accepted accounting principles is by a governmental directive—we'll be told that such and such are the accounting principles and, by the force of the government directive, we'll have generally accepted accounting principles.

I happen to believe that "generally accepted" should be established in another fashion. I think general acceptance should come from popular opinion, and since we are dealing with a technical matter the popular opinion can only come from those who are skilled, and that means that the most important element in determining what is "generally accepted" should be the accounting profession itself.

That puts a burden on each and every one of you, and if I were to voice any complaint about my experience in the matter of generally accepted accounting principles, my complaint would be that the members of the accounting profession do not in any adequate fashion indicate their ideas. The responses that we get are wholly inadequate.

What I would like to ask, then, simply is this: In anything which the Committee has done or which it proposes to do, take occasion once in awhile to give them an expression of your opinion. Any letter you write to the editor of the Journal of Accountancy or to the Director of Research will be brought to the attention of the Committee on Accounting Procedure, because the Committee is alert to this phase of the problem; it is very much interested in determining the popular opinion of the accounting profession.

In conclusion, I ask simply this: if our right to formulate generally accepted accounting principles is ever taken away from us or even if it is modified by government regulation or otherwise, let it not be said that that important right has been taken away from us because we were inarticulate.

Estate Administration and the Fiduciary's Accounting

A Review of the Steps in Estate Administration Which are Reflected in the Fiduciary's Accounting

By ARTHUR B. MOLL, C.P.A.

IN order for the practicing public accountant to have an understanding of the principles involved in fiduciary accounting, it is essential that he have a broad general background knowledge of the work of the executor in the administration of an estate. Accordingly, this paper will outline the more important steps of estate administration in the State of New York. All estates, of course, will not require consideration of every point covered. In fact, it is not at all likely that any estate will be so involved that every situation will be met; but during the course of time, the practitioner might readily be faced with almost any one of the numerous details mentioned herein.

The work of executor obviously starts when the testator dies. He takes whatever steps are necessary to obtain possession of the will and reads its contents to the immediate members of the family. Quite often there are important provisions of the will which require immediate attention, such as directions for burial, and the like. The will should then be presented to the Surrogate's Court for probate. The will of itself does not give the executor the right to take possession of the assets, pay the debts and make disstributions. The Court procedure should be adhered to in order to obtain its authority to administer the estate. A petition must be filed in which are stated the date of the will, the names of the witnesses, a statement regarding the residence of the testator at the time of his death and a complete listing of all interested parties, even if not named in the will. This list of interested parties should also include any guardians, trustees or other executors. The final portion of the petition is a request that the will be admitted to probate and that letters testamentary be granted.

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It is necessary that the executor obtain jurisdiction of all interested parties by whatever means are required, such as:

1. Getting a signed waiver of citation.
2. Publication of citation in the newspapers designated by the Surrogate.
3. By personally serving the interested party with a citation duly issued by the Court Clerk.
4. By one of several other means

indicated in the Surrogate's Court Act for special cases.

At the required time, the witnesses to the will must appear in the Surrogate's Court and give their depositions. After the Court has taken jurisdiction of the matter and the necessary parties and followed its procedure regarding witnesses and notices of probate, if no objections are filed, the will is admitted to probate. The executor must then qualify and file an oath of office, after which, letters testamentary are issued to him by the Court. He thus is put in immediate charge and possession of the assets of the deceased which are then to be administered in accordance with the terms of the will and the law of the state.

Taking actual physical possession of the assets should then be the next step in the estate administration. Cash in banks should be transferred to an account or accounts in the name of the estate. It will be necessary to obtain a waiver from the New York State Tax Commission before the banks will make this transfer. If there is a safe deposit box, a representative of the Tax Commission must be present when it is opened and an inventory of its contents is made. The title to securities, such as stocks and bonds, should be transferred to the executor as the representative of the estate. In the cases where the estate is the beneficiary of a life insurance policy, proper steps should be taken to have the proceeds paid to the executor. If the deceased was a member of a partnership, his interest therein should be determined and protected. With regard to real property, unless the will gives the executor authority to sell, the title passes directly to the specific or residuary devisee or to the trustee where a trust has been provided for. However, if there are insufficient other assets in the estate to pay the debts and administration expenses, the executor is permitted to sell, mortgage or lease it for the purpose of providing the necessary funds and of course then becomes accountable for the proceeds.

The records and personal effects of the deceased should always be examined for any possible clues to the existence of assets. If anyone is suspected of withholding assets belonging to the estate, a petition should be presented to the Court to start discovery proceedings to help in clearing up this matter.

An informal inventory should be prepared and also included therein should be the dividends declared prior to testator's death, accrued interest on bonds, and rents due at time of death on real estate owned by the deceased when he died. Values of assets at the time of death should be noted and if necessary, appraisals should be made by competent appraisers of those assets the value of which is not otherwise readily determinable, such as the stock of a closely held corporation, jewelry, collections of coins, or stamps and the like. For estate tax purposes, the value of real estate should also be determined.

Having obtained possession of the assets, the executor must decide what disposition to make of them. Some will be converted into cash immediately, or at the first opportune moment. Others may be continued in their present form, such as investments in sound legal securities. Certain other securities may be sold and the proceeds reinvested in those securities which are legal investments for estates. At all times, the executor must exercise great care in making and retaining investments to avoid the possibility of being surcharged for making improper investments. Even if the will permits the executor to invest in securities other than legal investments, he still must act in good faith and exercise "Care, diligence and prudence."

Now that the assets of the estate are in the possession of the executor, we come to the consideration of the first use to which they are put, namely, the payment of debts, funeral expenses and administration expenses. All those items of expense which are incurred

in connection with the burial of the deceased, provided they are commensurate with the size of the estate, may properly be paid by the executor. These expenses include the preparation for burial, cost of flowers, cost of death notices, cost of mourning apparel for the immediate family, the cost of a burial plot and an appropriate monument and perhaps perpetual care.

All those expenses of settlement of the estate incurred in the collection, liquidation and distribution of the assets constitute the administration expenses of the estate. They include such expenses as filing fees, attorneys' fees, accountants' fees, fees of special guardians in certain cases, costs of publication of citations and notices to creditors. Again, care should be exercised to avoid overpayment of any of these expenses. If in doubt regarding the amount of the attorney's fee, he may ask in the accounting proceeding to have the fee fixed by the Court. If the executor is also an attorney, he is entitled to an attorney's fee for the legal services he has rendered, but it is best that he ask the Court to determine the amount. Commissions of the executor, although a proper administration expense, are not paid during the administration period and hence do not appear in the accounting, but are awarded in the decree.

All those obligations which were incurred by the deceased during his lifetime, and remaining unpaid at the date of his death, constitute debts payable from the estate by the executor. All claims of creditors should be very carefully examined and unreasonable claims rejected in writing. Certain types of claims may be compromised if any doubt exists as to their validity. All claims should be presented in writing in affidavit form together with a statement that the full amount is due and unpaid. If there is any doubt about the solvency of the estate, the executor must observe the rule of priority in the payment of debts and administration expenses. The administration and funeral expenses are always payable prior to the debts. The order of priority for debts is as follows:—

1. Claims of the United States Government and the State of New York.
2. Judgment Claims of Creditors in the order in which they were docketed.
3. All other debts on an equal basis.

After all of the funeral expenses, administration expenses and claims of creditors have been provided for, the executor may now consider the distribution of the remaining estate according to the terms of the will. Under a will, there are three main kinds of legacies; the general legacy, which is a gift of a sum of money; the specific legacy, which is a specified part of the deceased's estate designated from all other parts; and the demonstrative legacy, which is a gift of a sum of money payable out of a particular fund. Quite often this distinction is very important. If the asset constituting a specific legacy has been disposed of prior to death, it ceases to be effective after death, and the specific legatee gets nothing. Also, general legacies are subject to abatement, that is, may be scaled down proportionately if there are not sufficient funds to pay all legacies in full.

A demonstrative legacy will be paid in full if the source designated in the will is sufficient, but if the source is not sufficient, the payment will equal the amount available, and the balance will be payable as a general legacy. The first class of legacies subject to abatement are the residuary legacies. Then follows the general and demonstrative legacies, but it is the usual practice to give preference to the payment of legacies which are given for a consideration, such as those given for support of dependents. All legacies of the same class abate proportionately.

If the executor has advertised for the presentation of claims of creditors,

he may start to pay legacies after the end of six months. Otherwise he should not pay legacies until the expiration of seven months from the date of issuance of letters testamentary. If a payment is made prior to this date, and a creditor presents a timely claim large enough to require the invasion of the legacies, the executor will be held personally liable to the creditors. A general or demonstrative legatee is therefore entitled to interest on his legacy seven months after the issuance of letters testamentary. A specific legatee is entitled to the income, if any, earned by his legacy from the date of death, such as dividends on stock or interest on bonds which were specifically described in the will.

Securities not sold during the administration of the estate may be turned over to the legatees as "payments in kind." In those cases where there are several legatees, a consent should be obtained to accept certain securities and to agree to the payment to the other legatees of the securities set aside for them. The value at date of delivery should be used by the executor in his records, as well as all accruals up to that time.

In a necessarily short outline such as this, there are many points which of course are not covered. The purpose here is to give a quick review without going into too much detail, and to cover every specific possibility would take much more time.

Other points which could be dwelt upon are the preparation of tax returns, both for taxes and estate taxes, and also the question of testamentary trusts and the difficulty of allocation between principal and income. However, there has been presented enough to give a picture of the events leading up to the accounting and to understand the type of transactions which are to be recorded in the records kept by the executor. In closing, it might be stated that the term "executor" was used for convenience, but much that has been said also applies to the duties of an administrator appointed by the Court.

It can be seen that the executor must rely a great deal on the attorney for guidance in all matters and of course it is not necessary to point out that there is plenty of need for an accountant's services.

Relationship of Executor's Accounting to Estate Administration

THE ACCOUNT

Schedule A. The Inventory

Contains a list of all personal property of the deceased using values established in the estate tax proceedings. Includes cash, stocks, bonds, accrued interest, insurance payable to the estate, dividends declared prior to decedent's death (no record date), miscellaneous property such as personal items, household effects, etc. Also rents due at date of death on real property and real property only if sold during administration.

THE ADMINISTRATION

The executor makes a diligent search of existing records and effects to ascertain the assets of which he should take possession. Cash balances in banks should be transferred. The safe deposit box of the deceased should be opened and examined and contents listed. Appraisals should be obtained for assets the value of which is not readily determined. Suits for the collection of assets should be instituted if necessary. Calculation of all accruals should be made. Title to stocks and bonds should be transferred to the executor. Insurance policies, where the estate is beneficiary, should be presented for payment. Business interests should be ascertained and protected and the value thereof determined.

Schedule A-1. Increases

A record of the gains resulting from the sale, liquidation, distribution or transfer of assets. Includes gains on later acquired assets as well as those in the original inventory.

Schedule A-3. Assets Collected at Par

A record of assets collected at no gain or loss on inventory value.

Schedule B. Decreases

A record of the losses resulting from the sale, liquidation, distribution or transfer of assets.

Schedule B-1. Uncollectible Items

A record of all inventoried assets or later acquired assets which have no value.

Schedule G. New Investments

A record of all new investments made during administration as well as exchanges made.

In the proper administration of an estate, it is the duty of the executor to reduce the assets to proper form for the protection of values. Investments may be sold or called and new investments made. Business interests may be liquidated. Mortgages may be collected or modified or otherwise changed. Changes from non-legal investments to legal investments may be necessary. Exchanges may be required. If cash is needed in the estate, real estate may be sold. Insurance policies may be collected and the proceeds not immediately required for other purposes may be invested.

Schedule C. Funeral and Administration Expenses

A complete listing of all of the funeral expenses as well as all expenses of administration.

Schedule C-1. Unpaid Funeral and Administration Expenses

Contains a list of all items of this character which remain unpaid at the time of the accounting.

Schedule E. Payments to Creditors

A complete statement of all claims of creditors paid. This is supplemented by the following Schedules:

Schedule D. Claims of Creditors
Schedule D-1. Preferred Claims
Schedule D-2. Personal Claims
Schedule D-3. Rejected Claims

These are informative Schedules only.

It is the duty of the executor to pay all the reasonable expenses incurred in connection with the burial of the deceased. The expenses of administration of the estate are those incurred in the collection, liquidation and distribution of the assets. These include the attorneys' fees, commissions, filing costs, accountants' fees, costs of publication of citations and notices to creditor. All the debts of the deceased become payable by the estate, but the executor must exercise great care in passing on the claims which are presented. Unpaid funeral and administration expenses are passed upon at the accounting proceeding and if approved are ordered paid in the decree.

Schedule F. Payments to Legatees or Trustees

Contains a statement showing all of the personal property delivered or paid to legatees or trustees. Also includes specific legacies. Value at time of distribution is used. Amount of prorated taxes (in a proper case) charged to legatees is also shown.

Under the will, the personal property is payable to certain legatees, or to trustees where trusts have been set up. The executor must exercise care in making distributions, usually considering such factors as preference, time of payment, the proper persons to receive the legacies and whether or not interest accrues on the legacy. The terms of the will and the condition of the estate are deciding factors.

Schedule A-2. Income Received

The income collected during the period of administration is recorded in this Schedule. It is further supported by the following:

Schedule C-2. Expenses Charged to Income

Schedule F-1. Income Payments to Beneficiaries

The executor should keep a separate record of each item of income received during the period of administration. Where a trust is indicated in the will, expenses properly chargeable to income should be separately recorded. The payments to beneficiaries or trustees of income also should be kept apart in the records. The allocation between Corpus and Income of expenses is a very important matter where a trust has been set up.

Schedule H & H-1. Balances on Hand

These two Schedules are statements of all funds remaining in the hands of the executor at the end of the period of administration. These include the balances of Corpus as well as Income.

The executor's records must at this point indicate exactly what is left in the estate and a listing made of items of stocks, bonds, other investments, cash and other assets should equal the balance remaining for which he is accountable. This is true for Income as well as Corpus, each of which should be recorded separately.

Schedule I. Statement of Interested Parties

Contains a list of names, addresses and approximate value of their interest in the estate of all interested parties. Assignments, Powers of Attorney and encumbrances made and executed by interested parties are also listed.

The executor must look after the interests of all persons who may have any interest in the estate, however remote. He should have the records of the surrogate's court searched for any Powers of Attorney, assignments and encumbrances made and executed by interested parties.

Schedule J. Allocation of Taxes

A statement of the proposed method of allocation of the Federal and New York estate taxes, or a statement that no allocation is required because of a provision of the will.

Unless the will exempts the interested parties from paying their proportionate share of the Federal and New York estate taxes, a calculation must be made before making any distributions. This calculation of the allocation may be quite involved and a statement should be prepared showing all the steps taken.

Schedule K. Computation of Commissions

Contains a statement showing the computation of commissions to which the executor believes he is entitled. Separate calculations should be made for principal and income where a trust is involved.

Schedule L. Other Facts Affecting Administration

This is a statement of all other material facts affecting the administration. This would include a listing of real property which the executor would not otherwise be required to account.

When the executor has completed his administration of the estate, and is preparing his account, it will be necessary for him to calculate the amount of commissions to which he is entitled as his compensation. The principal and income portions of the calculations should be shown separately in every case where a trust is set up by the will.

In addition to recording all of the monetary transactions of the administration, the executor should keep a running account of all steps he has taken and all material facts pertaining to the estate which are not otherwise recorded. Some of these facts may be informative to the Surrogate's Court and the interested parties and should be presented as general information in his account.

An Accounting System for a Decedent's Estate

By Abraham J. Briloff, C.P.A.

MR. MOLL, in his paper on "Estate Administration and the Fiduciary's Accounting" has told us about the various steps involved in the administration of a decedent's estate, culminating in the Account of Proceedings; we have seen that the Executor's Account of Proceedings must recapitulate the various transactions involving the Assets of the estate during the period covered by his Account. Let us now direct our attention to the records upon which the executor may rely in the preparation of the Accounting.

The account of Proceedings could be, and frequently is prepared from the check book and fragmentary records maintained by the executor. The weaknesses of this procedure are many, among them:

1. Many transactions, especially those which do not involve cash, frequently go unrecorded.

2. The time consumed in the piecing together of various data is generally greater than that which would have been involved in the preparation of a complete set of double entry records.

3. All too frequently the attempt to trace the various transactions during the period covered by the account proves to be unsuccessful.

4. No satisfactory records are available for tax purposes.

Abraham J. Briloff, C.P.A., has been a member of the Society since 1941. He holds the degree of B.B.A. from the City College of New York. Mr. Briloff is a teacher of accounting at Tilden High School in Brooklyn, and he is a partner of Apfel and Englander.

The alternative to the use of the check book and memorandum data lies in the maintenance of a complete set of books on the principle of double entry. A proper system of accounts will assist the Executor in many ways, for example, it will:

1. Furnish him with the basis for his Account of Proceedings.

2. Furnish him with the data necessary to prepare properly the estate, inheritance and income tax reports.

3. Furnish him with the data which will indicate the financial condition of the estate.

4. Assist the fiduciary in the proper management of the estate, (e.g. in the collection of income.)

5. Assist the executor in safeguarding the assets of the estate.

As had been indicated previously, the use of the principles of double entry is advisable. The fundamental equation in fiduciary accounting is Assets=Accountability, rather than the usual equation found in commercial accounting, Asset=Liabilities+Capital.

The reason for the different equation lies in the difference in the philosophy underlying the two systems of accounts. Whereas commercial accounting is predicated on the premise that profitable operation and continuity of existence are the primary motives of the entrepreneur, fiduciary accounting proceeds upon the premise that collection, liquidation and distribution are the basis motives of the executor.

The equation Assets=Accountability indicates that the assets which the executor has in his possession at any time represents the extent of his responsibility or accountability to the court from which his authority stems. The principles of debit and credit applied to the fundamental equation in fiduciary accounting are similar to those applied to commercial accounting, in that a debit represents an *increase* in an *asset* or a *decrease* in the *accountability* and a credit represents a *decrease* in an *asset* or an *increase* in the *accountability*.

The books of account to be maintained by the executor are as follows:

1. The General Journal

2. The Cash Book (a) Cash Receipts (b) Cash Payments

3. The Ledgers

 (a) The General Ledger

 (b) Subsidiary Ledgers (re securities, real estate, etc.)

The accompanying illustrations are intended to indicate the form and operation of the various books named above (with the exception of the subsidiary ledgers.) Transactions have been selected which would illustrate the principles discussed herein. In an actual instance there would be many transactions of the type set forth herein. Further, as Mr. Moll has indicated in his paper, the administration of an estate generally involves many months and sometimes year; but for the purpose of this illustration the transactions have been telescoped into a single month.

(a) Robert Allen died a resident of the City and County of New York on the 1st day of February, 1945. Arthur Young and the Safety Trust Company were named co-executors. The assets of the estate consisted of the following, valued as of the date of death:

$10,000 face value XYZ bond, interest at 5%, payable May and November 1, valued at 110	$11,000.00
Accrued interest on XYZ bond from November 1 to Feb. 1	125.00
250 shares DEF stock, valued at 60	15,000.00
100 shares ABC stock, valued at 50	5,000.00
Cash in the National City Bank of N. Y.	10,000.00
Non-interest bearing note made by S. J. Thomas, dated January 10	500.00
Total Estate	$41,625.00

(b) On February 6, transferred the balance standing to the credit of the deceased in the National City Bank to an account in the name of the estate, at the Safety Trust Co.

(c) On February 7, sold the ABC stock at 53.

(d) On February 8, collected the amount due on the S. J. Thomas note.

(e) On February 9, received dividends declared February 2 on the DEF stock at the rate of $1.00 per share.

(f) On February 10, paid Dr. Sidney Strong $100 for professional services during last illness.

(g) On February 11, paid a bill submitted by Lord & Taylor, representing purchases made by the deceased—$55.00.

(h) On February 14, paid $3.00 for copies of the letters testamentary.

(i) On February 15, paid a bill submitted by the Campbell Funeral Chapel—$625.00.

(j) On February 16, sold the XYZ bond for $10,800.00 plus accrued interest from November 1, 1944, $145.83.

(k) On February 18, paid $380 to the Collector of Internal Revenue, as the final payment on account of 1944 income taxes due on income received by deceased.

(l) On February 22, paid $14.50 to the New York Telephone Co. for telephone service for the month of January.

(m) On February 24, paid a legacy of $1,000 bequeathed to the Tribune Fresh Air Fund.

(n) On February 28, bought $5,000 face value USA Treasury, 2½% bonds for $5,050, plus accrued interest ($10.)

ESTATE OF ROBERT ALLEN, DECEASED
JOURNAL

Analysis of Provisions of the Last Will and Testament of Robert Allen, Deceased

Will dated: October 6, 1943
Date of Death: February 1, 1945
Will Probated and Letters Testamentary Issued: February 6, 1945

Here follows a summary of the provisions of the Last Will and Testament

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As of February 1, 1945

Inventory—Stocks	211	20000	00		
Inventory—Bonds	212	11125	00		
Inventory—Cash	213	10000	00		
Inventory—Notes Receivable	214	500	00		
Estate Principal Account	301			41625	00

To open the books of the estate of Robert Allen, in accordance with the inventory of the assets of said decedent prepared by the executor.

(Here follows the inventory as set forth in the narrative.)

ESTATE OF ROBERT ALLEN, DECEASED

CASH RECEIPTS BOOK

Date 1945		Name and Explanation	Amount of Deposit	Principal Cash	Income Cash	PRINCIPAL Receipts from Sale or Realization: Decreases	Inv. Value	Increases	INCOME: Dividends	Interest
Feb.	6	National City Bank Transfer...........	10,000.00	10,000.00			10,000.00			
	7	Proceeds of sale—100 shares ABC stock at 53	5,300.00	5,300.00			5,000.00	300.00		
	8	Proceeds—S. J. Thomas note...........	500.00	500.00			500.00			
	9	Dividend—250 shares DEF stock at $1.00	250.00		250.00				250.00	
	16	Proceeds of sale $10,000 XYZ bond @ 108 and accr. int..........................	10,945.83	10,925.00	20.83	200.00	11,125.00			20.83
			26,995.83	26,725.00	270.83	200.00	26,625.00	300.00	250.00	20.83
			(101)	(201)	(401)	(321)	Analysis (213) 10,000 (211) 5,000 (214) 500 (212) 11,125	(311)	(502)	(501)

NOTE: In order to conserve space no provision has been made herein for "general" columns in the principal or income sections.

Date 1945		Name and Explanation	Check No.	Amount of Check	Principal Cash	Income Cash	PRINCIPAL: Funeral and Adm. Exp.	Debts of Decedent	Legacies	General	INCOME: General
Feb.	10	Dr. Sidney Strong—prof. services—last illness	1	$ 100.00	$ 100.00			$100.00			
	11	Lord & Taylor merchandise purchased	2	55.00	55.00			55.00			
	14	Cash—copies of letters testamentary..	3	3.00	3.00		$ 3.00				
	15	Campbell Funeral Chapel—funeral....	4	625.00	625.00		625.00				
	18	Collector of Internal Revenue final 1944 tax	5	380.00	380.00			380.00			
	22	New York Telephone Company January services	6	14.50	14.50			14.50			
	24	Tribune Fresh Air Fund legacy......	7	1,000.00	1,000.00				$1,000.00		
	28	Hirsch & Co.—Purchase $5,000 US 2½%—'67 and accr. int..........	8	5,060.00	5,050.00	$10.00				$5,050.00	$10.00
				$7,237.50	$7,227.50	$10.00	$628.00	$549.50	$1,000.00	$5,050.00	$10.00
				(101)	(201)	(401)	Analysis (331) $ 3. (332) 625.	(333)	(341)	(251)	(541)

Estate of Robert Allen, Deceased | **General Ledger Accounts**

#101 Cash—Safety Trust Co.—Memorandum Account

1945					1945		
Feb. 28			CR	$26,995.83	Feb. 28	CP	$ 7,237.50

#201 Principal Cash

1945					1945		
Feb. 28			CR	$26,725.00	Feb. 28	CP	$ 7,227.50

#211 Inventory—Stocks

1945					1945		
Feb.	1	100 sh. ABC @ 50	J	$ 5,000.00	Feb. 28	CR	$ 5,000.00
	1	250 sh. DEF @ 60	J	15,000.00			

#212 Inventory—Bonds

1945					1945		
Feb.	1	10M XYZ—5%	J	$11,000.00	Feb. 28	CR	$11,125.00
	1	accrued int.	J	125.00			

#213 Inventory—Cash

1945					1945		
Feb.	1	National City	J	$10,000.00	Feb. 28	CR	$10,000.00

#214 Inventory—Notes Receivable

1945					1945		
Feb.	1	S. J. Thomas	J	$ 500.00	Feb. 28	CR	$ 500.00

#251 Investments (Principal) Bonds

1945							
Feb. 28			CP	$ 5,050.00			

#301 Estate Principal Account

					1945		
					Feb. 1	J	$41,625.00

#311 Increases on Sale or Realization

					1945		
					Feb. 28	CR	$ 300.00

#321 Decreases on Sale or Realization

1945							
Feb. 28			CR	$ 200.00			

#331 **Expenses of Administration**

1945
Feb. 28..................CP $ 3.00

#332 **Funeral Expenses**

1945
Feb. 28..................CP $ 625.00

#333 **Debts of the Decedent**

1945
Feb. 28..................CP $ 549.50

#341 **General Legacies**

1945
Feb. 28..................CP $ 1,000.00

#401 **Income Cash**

1945	1945
Feb. 28..................CR $ 270.83	Feb. 28......CP $ 10.00

#501 **Income—Interest**

	1945
	Feb. 28......CR $ 20.83

#502 **Income—Dividends**

	1945
	Feb. 28......CR $ 250.00

#531 **Expenses of Administration—Income**

Post here all expenses chargeable against income

#541 **Other Expenditures Chargeable against Income**

1945 Feb. 28 Accrued int. paid on purchase.....CP $ 10.00	This charge would be transferred to account number 501 when the interest on the investment is ultimately collected

#551 **Payments to Income Beneficiaries**

Post here all distributions to income beneficiaries

ESTATE OF ROBERT ALLEN, DECEASED — FEBRUARY 28, 1945

		Trial Balance		Corpus		Income		Reflected in Proceedings Schedule
101	Cash Safety Trust Co. (memo) $19,758.33....							
201	Principal Cash	$19,497.50		$19,497.50				H
211	Inventory—Stocks	15,000.00		15,000.00				H
251	Investments (Principal) Bonds	5,050.00		5,050.00				H
301	Estate Principal Account		$41,625.00		$41,625.00			A
311	Increases on Sale or Realization		300.00		300.00			A-1
321	Decreases on Sale or Realization	200.00		200.00				B
331	Expenses of Administration	3.00		3.00				C
332	Funeral Expenses	625.00		625.00				C
333	Debts of the Decedent	549.50		549.50				E
341	General Legacies	1,000.00		1,000.00				F
401	Income Cash	260.83				$260.83		H-1
501	Income—Interest		20.83				$ 20.83	A-2
502	Income—Dividends		250.00				250.00	A-2
531	Exp. of Administration—Income							C-2
541	Other Exp. chargeable against Income	10.00				10.00		C-2
551	Payments to Income Beneficiaries							F-1
		$42,195.83	$42,195.83	$41,925.00	$41,925.00	$270.83	$270.83	

The Nature of Principal and Income in Fiduciary Accounting and Notes on Current Developments

By John J. Traynor, C.P.A.

I. Introduction

THE purpose of this paper is to review in somewhat summary fashion the nature of Principal and Income in fiduciary accounting and to discuss certain current developments in that field.

In ordinary commercial enterprise, where profit is the primary motive, business in a sense is accountable to itself and the accounting is accomplished by the application of more or less generally accepted principles and procedures. In fiduciary accounting, on the other hand, the underlying philosophy is the accountability of the fiduciary for the properties entrusted to his care and management. For manifest reasons, therefore, fiduciary accounting is influenced and dominated throughout by law.

How an Estate or Trust Comes Into Being

An estate comes into being upon the death of a person possessed of property. If the decedent dies testate, that is, by leaving a valid last will and testatment, his estate passes in accordance with his testamentary directions; if he dies intestate, the estate is distributed in accordance with the provisions of law. The estate is administered by the executor or executors nominated by the testator, or by an administrator appointed by the court if the executors fail to qualify, or if the decedent dies intestate.

John J. Traynor, C.P.A., was elected to membership in the Society in 1928 and he is active on the Committee on Fiduciary Accounting. He attended New York University. He is associated with the law firm of Breed, Abbott and Morgan.

A trust may be created under a decedent's will or by an agreement entered into by living persons. The trust, whether testamentary or otherwise, is administered by one or more designated trustees.

The Fiduciary's Responsibility Accounting-Wise

Broadly, the fiduciary is accountable for the estate or trust fund in two ways:

1. As to the fund in its entirety and in relation to claimants, other than beneficiaries;
2. As to the respective rights of the persons entitled to share in the fund and its income.

This discussion will deal only with the latter and only in so far as the rights of beneficiaries may be affected by certan questions airsing between Principal and Income.

Principal and Income Defined

Principal or Corpus refers to the property or fund entrusted to the fiduciary. In an estate, it represents the property passing from the deceased to the executor or administrator. In a trust, it is the property received by the trustee for administration.

Income generally is the ordinary meaning of the term—the yield or return on Principal, except as modified by testator's or grantor's expressed intention, or by law.

Necessity for Segregating Principal and Income

Unless an estate passes outright, i.e., without any part going into trust, it is essential that a fiduciary make careful distinction in his accounts as between Principal and Income. It is the trustee's duty to provide Income benefi-

ciaries (life tenants) with the Income earned and, at the same time, preserve the trust corpus or Principal for its ultimate owners (remaindermen). Consequently, each item of receipt and expenditure must be properly classified as to Principal or Income. This gives rise to many questions, a selected number of which will now be considered.

II. Current Problems

Accrual of Ordinary Dividends on Stocks

Income accruals play an important part in the apportionment between Principal and Income and in this connection, one of the most common questions is whether a dividend accrues as of date of declaration or date of record.

The confusion comes about by reason of the fact that when a corporation declares a dividend, it sets the amount thereof aside as a liability to stockholders as a class but without certainty, until record date, as to which members of the class shall be entitled to the dividend.

For many years, dividends have been accrued in fiduciary accounts as of date of declaration (*Matter of Kernochan,* 104 N. Y. 618 (1887); *Ford* v. *Snook,* 205 App. Div. 194, affirmed 240 N. Y. 624 (1923); see also *Matter of Booth,* 139 Misc. 253 and *Matter of Wolfe,* 155 Misc. 190). This practice has been followed generally, or at least until April 24, 1930, on which date Section 62 of the Stock Corporation Law of New York became effective and provided that a stockholder's right to a dividend accrues as of date of record.

In 1942, Surrogate McGarey of Kings County held in the *Matter of Robb,* 178 Misc. 240, that "the rights of the respective beneficiaries of a trust or claimants to a dividend in an estate, should be determined by their status on the record date, in the absence of any controlling provision in the law." In this case, it was held that dividends declared during the life of the primary life beneficiary and payable to stockholders of record after the death of said beneficiary were payable to the secondary life beneficiary.

Shortly afterward, in 1942, Surrogate Foley, in the *Matter of Bashford* (178 Misc. 951), which involved the right to dividends as between a deceased life tenant and remaindermen, relying particularly on said change in Stock Corporation Law, held in effect that dividends accrue as of date of record where the law of the state of incorporation of the declaring corporation fixes stockholders' rights as of a record date.

However, in 1943, Surrogate Delehanty, in the *Matter of Depew* (179 Misc. 1074) held that dividends declared during the life of the income beneficiary but payable to stockholders of record after the death of the beneficiary were payable to the estate of the deceased beneficiary and not to the remaindermen of the trust.

Subsequently, in a case involving a dividend declared before decedent's death but payable to stockholders of record after his death, Surrogate Delehanty held the dividend to be payable to Income. *Estate of Owen B. Winters,* New York Law Journal, January 27, 1944, p. 353. In this case, the dividend was declared long in advance of payment date.

Since then, in the *Matter of Goldman,* not yet officially reported, the date of record rule, as aforesaid, was upheld in a decision handed down by Surrogate Foley and affirmed by the Appellate Division (4 to 1). However, an appeal has been taken to the Court of Appeals and it is understood that argument was set down for the last week in October.

Until the point is finally settled in this state, it is suggested that a conservative procedure be followed. In accruing dividends as of date of death or as of date Principal is placed in trust, the use of declaration date would obviate overpayment of Income. On termination of a trust or in fixing the rights of

primary and secondary life beneficiaries, the use of record date would seem to be in order. But in any case, it would be well to withhold actual distribution of dividends in question, pending approval of an accounting.

In connection with this question, it is worth noting that in a recent income tax case under Sec. 42, 1938 Act, the U. S. Supreme Court held that dividends declared before decedent's death but payable to stockholders of record on dates falling after his death did not accrue on declaration date as "such a declaration leaves the identity of the recipient at large" since it was not certain that the person then the stockholder would receive the dividend. *Est. of Henry W. Putnam* v. *Comm'r.* (U. S. Sup. Ct.) March 26, 1945, revg. CCA 2, 144 Fed. (2) 756.

Dividends in Arrears

In a recent accounting proceeding (*Matter of Wittenberg*, 57 N.Y.S. (2) 476), it became necessary to determine whether any apportionment between Principal and Income should be made of dividends collected by the trustees on certain preferred shares. The shares were purchased by the trustees at a price of 119⅞ per share and at the time of purchase, dividends were in arrears to the extent of $16.25 per share. About ten and a half months after purchase, part of the accumulated dividends were paid and within nineteen months, the entire accumulation had been cleared.

In respect of accumulated dividends paid on shares received by trustees under the will of a deceased testator or by trustees from the grantor of an *inter vivos trust* (where such dividends had not accrued to Principal as of date of death or date such shares became part of trust Principal), the Court stated, "It appears to be well settled that such dividends are payable wholly to income account although a portion of the payments represents accumulations already existent at the time of creation of the trust" and cited Restatement of the Law of Trusts, section 236, subdivision q; *Thompson* v. *New York Trust Co.*, 107 Misc. 245, aff'd. 191 App. Div. 904; *In re Fisher's Estate*, 344 Pa. 607, 26 A. 2d 192; *Matter of Lander*, 162 Misc. 201.

The Court noted that "the element not present in the cited authorities, but here present is that the shares were bought by the trustees themselves and were not the property of the testator at the time of his death."

The Surrogate observed that because of the many factors entering into a market price of a security of general distribution, the Court would meet insuperable difficulties if it attempted to relate the existence of the accumulations to the market price paid, and that "because the authorities cited furnish at least an analogy and because any different rule must be based on pure speculation," the Court held the dividends in this case to be payable entirely to Income. (Cited, *Matter of Bliss*, 57 N.Y.S. (2) 475.)

Although this decision is consistent with the general rule that accumulated dividends when received are not extraordinary and not apportionable, but are ordinary dividends and belong to Income (*Matter of Palmer*, 167 Misc. 624 (1938); *Thompson* v. *New York Trust Co., supra*), the result obtained here seems to favor Income at the expense of Principal.

How, in the ordinary course of events, can Principal, in this case, recoup that portion of the purchase price which represented dividend accumulations? True, at the time of purchase it would have been pure speculation to have assigned an exact investment value to such accumulations. Nevertheless, on the basis of the facts that the shares were purchased at a price well in excess of $100 and that the arrearages were cleared up so soon after purchase, a more equitable treatment would have been obtained by crediting Principal with either the entire dividend or such portion as would have preserved the amount of Principal originally invested.

Stock Dividends

Section 17-a of the Personal Property Law was amended on May 17, 1926, to provide that any stock dividends received by any trust estate created by a will, deed or other instrument executed after that date, and in respect of any stock composing in whole or in part the Principal of such trust shall be Principal and not Income of such trust, unless otherwise provided by the instrument.

In the *Matter of Villard*, 147 Misc. 472 (1933) it was originally held that stock dividends paid regularly from current earnings were not true stock dividends as contemplated under Section 17-a, and hence not Principal.

However, in the *Matter of Ryan*, 294 N. Y. 85, the Court of Appeals, on March 1, 1945, reversed the *Villard* rule and held that under Section 17-a of the Personal Property Law, all stock dividends, including ordinary dividends paid in stock out of current earnings must be allocated to Principal.

The aforesaid rule is not applicable to stock dividends received by any trust estate created by a will, deed or other instrument executed on or before May 17, 1926. In such cases, it is necessary to apportion the stock dividends between Income and Principal if the dividend results in an impairment of Principal. The object, therefore, is to credit Principal with such portion of the stock dividend as will restore the original investment at *book value*. The rule for allocating extraordinary dividends, whether cash or stock, was laid down in the *Matter of Osborne*, 209 N. Y. 450.

Premium and Discount Bonds

1. As to testamentary trusts created by wills of persons dying after September 1, 1942, and trusts created by deed or other instrument executed after that date, it is no longer necessary to amortize premiums on bonds purchased by a trustee, unless the terms of the trust provide otherwise. Section 17-d was added to the Personal Property Law as of that date and subsection (1) reads:

> "Unless otherwise provided by the terms of the trust, when any part of the principal of a trust consists of bonds or other obligations for the payment of money, such bonds or other obligations shall be deemed principal at the inventory value, or if there be no inventory value, at the market value of such bonds or other obligations at the time the principal was established, or at their cost where purchased later, regardless of their par or maturity value; and upon their respective maturities or upon their sale any loss or gain realized thereon shall fall upon or enure to the principal."

As to trusts affected, the foregoing will materially simplify the accounting for interest income.

In accounting for discount bonds such as United States Savings Bonds, the following was added to the Personal Property Law as Section 17-d (2), effective similarly as to estates and trusts created after September 1, 1942:

> "Unless otherwise provided by the terms of the trust, when any part of the principal of a trust consists of a bond or other obligation for the payment of money, bearing no stated interest but redeemable at maturity or a future time at an amount in excess of the amount in consideration of which it was issued, the amount of such accretion earned during the period that such bond or other obligation was held by the trustee, shall enure to income."

2. As to testamentary trusts created by wills of persons dying before September 1, 1942 and trusts created before that date, it is still necessary to amortize the premiums on bonds purchased during the administration of the estate or trust, unless the instrument provides otherwise. (*Matter of Stevens*, 187 N. Y. 471 (1907); *Furniss* v. *Cruikshank*, 191 App. Div. 450, 230

N. Y. 495; *Matter of Brewster,* 163 Misc. 820 (1937).)

Where bonds are purchased at a discount, accumulation is not required. Principal is credited with gain on disposition. (*Townsend* v. *U. S. Trust Co.,* 3 Redf. (N.Y.) 220; *Matter of Gerry,* 103 N. Y. 445.)

No amortization is required with respect to bonds held by the fiduciary which were held by the testator at the time of his death. (*Matter of Stevens, supra; Robertson de Brulatour,* 111 A.D. 882 (1906); *Estate of Samuel C. Van Dusen,* N.Y.L.J., Feb. 5, 1937.)

On sale or redemption prior to maturity, the unamortized premium must be borne by Principal. (*Farwell* v. *Tweadle,* 10 Abb. N.C. (N.Y.) 94; *Whittemore* v. *Beekman,* 2 Demarest (N.Y.) 275; *Matter of Brewster, supra.*)

Where bonds are sold or called for redemption at a price in excess of the amortized cost of the bonds, the profit belongs to Principal and no reimbursement is required to be made to Income in respect of premium amortization previously deducted on such bonds. (*Matter of Depew,* 179 Misc. 1074 (1943.)

Amortization of Improvements to Real Estate

Where unusual or extraordinary repairs or permanent improvements to real estate are made, it has been a recognized rule that the cost should be apportioned between Principal and Income (*Stevens* v. *Melcher,* 152 N.Y. 551). However, the modern trend seems to be to amortize the improvements out of Income over their useful life. This principle is illustrated in the *Matter of del Drago* (179 Misc. 383). In that estate, improvements were made to a number of real properties left in trust. As the improvements enhanced the rental values of the property, it was held that their cost was properly amortizable against income over their estimated life. This is really "depreciation" under another name.

Mortgage Foreclosures

Where an estate or trust holds mortgages on real estate and one or more of such mortgages goes into default and the fiduciary forecloses or takes a deed in lieu thereof and holds the property for operation and subsequent sale, the entire transaction from foreclosure to ultimate sale is technically known as a salvage operation. The accounting problem presented is to determine the respective interests of Principal and Income in the net amount realized on operation and sale.

The rules to be followed are stated in the leading cases of *Matter of Chapal,* 269 N.Y. 464 (1936) and *Matter of Otis,* 276 N.Y. 101 (1937), in Section 17-c of the Personal Property Law, enacted April 13, 1940, and in decisions since handed down. Section 17-c was added to simplify the *Chapal* and *Otis* rules. The particular procedure to be followed depends generally upon whether the estate or trust came into being *by* or *after* April 13, 1940 and whether the mortgage investment was made by or after that date.

1. Where the mortgage was held prior to April 13, 1940 and the salvage operation completed by that date, the *Chapal-Otis* rules are applicable (*Matter of West,* 289 N.Y. 423 (1943)) and the procedure generally is as follows:

> Net income from operation of the property shall be applied to reimburse Principal for foreclosure expenses and carrying charges;
>
> Net proceeds of sale on final liquidation shall be applied first to reimburse Principal for the balance of any advances to pay foreclosure expenses and carrying charges, including expenses necessary to put the property in rentable or saleable condition, and the balance shall be apportioned between Principal and Income. For purpose of apportionment, the interest of Principal is the face amount of the mortgage and the interest of Income the amount of unpaid interest from date of default

to date of sale, at the rate specified in the bond.

2. Where the mortgage was held prior to April 13, 1940 and the salvage operation completed after that date, the *Chapal-Otis* rules for apportionment are continued but with the modification prescribed by Section 17-c (2) of the Personal Property Law. This section provides that

> Net income during the salvage operation up to 3% annually upon the principal amount of the morgage shall be paid to the life tenant regardless of principal advances for the expense of foreclosure or conveyance and arrears of taxes and other liens which occurred previously and the cost of all capital improvements;
>
> Any such payment of net income shall be final and not subject to recoupment, or surcharge, but the amount of all such payments shall be taken into account in the apportionment of the proceeds of sale to life tenant;
>
> The principal advances shall be paid out of any excess net income above such 3%. When principal advances have been satisfied, any excess income shall be impounded to await sale and apportionment;
>
> The unpaid principal advances shall be a primary lien upon the proceeds of sale and shall be paid first out of any cash so derived and if such cash be insufficient, the balance shall be a primary lien upon any purchase money mortgage received.

For more detailed answers to accounting questions arising under salvage operations, the opinion of Surrogate Foley in the *Matter of West,* 175 Misc. 1044 (1941) should be helpful. See also *Matter of Culver,* 57 N.Y.S. (2) 598 (1944); *Matter of Manger,* 57 N.Y.S. (2) 521 (1945).

3. As to estates of persons dying after April 13, 1940, trusts created under an agreement executed after that date and to investments of mortgages thereafter made by a trustee of an existing trust, the real property acquired by foreclosure becomes a principal asset in lieu of the mortgage. The life tenant shall be entitled to the net income from such property from date of acquisition and no apportionment of proceeds of sale shall be made.

III. CONCLUSION

In conclusion, it is suggested that in each estate or trust to be accounted for, the will or trust instrument be read and studied carefully and that all questions of law be submitted to counsel.

ILLUSTRATIVE STATEMENTS OF A MORTGAGE SALVAGE OPERATION

I. Where Mortgage Held Prior to April 13, 1940 and
   (a) Salvage Completed *by* that Date;
   (b) Completed *after* that Date.

II. Where New Mortgage Investment Made After April 13, 1940 or Where Mortgage Held by Estate of Person Dying or by Trust Created After That Date.

Facts

Investment in 6% mortgage at par	$13,000.00
Foreclosure expenses paid	$ 1,453.12

Net income from operation of property to date of sale:			
First fiscal year........................	Loss	($200.00)	
Second fiscal year	Profit	800.00	
Third fiscal year (to date of sale)........	Profit	59.06	$ 659.06
Interest on mortgage at 6% from date of default to date of sale			$ 2,109.66
Property sold for		$8,500.00	
(Cash $4,500 and Purchase Money Mortgage $4,000)			
Expenses of sale............................		583.62	
Net Proceeds of Sale..............................			$ 7,916.38

I. (a) *Where Mortgage Held Prior to April 13, 1940 and Salvage Completed by that Date*

(Chapal-Otis Rules Applicable)

	Total	**Cash**	**Mortgage**
Amount to be Apportioned:			
Net proceeds of sale............	$ 7,916.38	$ 3,916.38	$ 4,000.00
Plus, net income from operations.	659.06	659.06	—
Total.................	$ 8,575.44	$ 4,575.44	$ 4,000.00
Less, foreclosure expenses to be reimbursed to Principal.......	1,453.12	1,453.12	—
Balance, representing the amount available for apportionment....	$ 7,122.32	$ 3,122.32	$ 4,000.00

Investment for Purpose of Apportionment:	**Total**	**Principal**	**Mortgage**
As to Principal:			
Face value of mortgage.......	$13,000.00	$13,000.00	$ —
As to Income:			
Interest in default...........	2,109.66	—	2,109.66
Total.................	$15,109.66	$13,000.00	$ 2,109.66
%..................	100%	86.0377%	13.9623%
Apportionment:			
Cash	$ 3,122.32	$ 2,686.37	$ 435.95
Mortgage	4,000.00	3,441.51	558.49
Total.................	$ 7,122.32	$ 6,127.88	$ 994.44

Distribution of Total Amount
Realized on Operation and Sale:

	Total	Cash	Mortgage
To Principal:			
Foreclosure expenses advanced	$ 1,453.12	$ 1,453.12	$ —
Share due on apportionment..	6,127.88	2,686.37	3,441.51
Total due Principal......	$ 7,581.00	$ 4,139.49	$ 3,441.51
To Income:			
Share due on apportionment and payable to life tenant...	$ 994.44	$ 435.95	$ 558.49
Total..................	$ 8,575.44	$ 4,575.44	$ 4,000.00

I. (b) *Where Mortgage Held Prior to April 13, 1940 and Salvage Completed after that Date*

(Chapal-Otis Rules, as modified by Section 17-c (2), Personal Property Law, Applicable)

Amount to be Apportioned
Investment for Purpose of Apportionment
Apportionment

To be as set forth in I. (a) before.

Distribution of Total Amount Realized on Operation and Sale:

		Total	Cash	Mortgage
To Principal:				
Foreclosure expenses advanced...		$ 1,453.12	$ 1,453.12	$ —
Share due on apportionment.....		6,127.88	2,686.37	3,441.51
Total due Principal.....		$ 7,581,00	$ 4,139.49	$ 3,441.51
To Income:				
Share due on apportionment and payable to life tenant..........		$ 994.44	$ 435.95	$ 558.49
Less, payments under 3% rule:				
First fiscal year.....	$ —			
Second fiscal year...	390.00			
Third fiscal year to date of sale......	—	390.00	390.00	—
Balance to life tenant............		$ 604.44	$ 45.95	$ 558.49
Combined Total		$ 8,185.44	$ 4,185.44	$ 4,000.00

II. *Where New Mortgage Investment Made After April 13, 1940 or Where Mortgage Held by Estate of Person Dying or by Trust Created After That Date*

(Section 17-c (1), Personal Property Law, Applicable)

As to Principal

The real property acquired on foreclosure becomes a principal asset in lieu of the mortgage and is set up at the carrying value of	$13,000.00
The expenses of foreclosure are added to the inventory value	1,453.12
Making the carrying value of the real property.	$14,453.12
On sale, the entire net proceeds are credited to Principal, without apportionment	7,916.38
Resulting in a loss to be borne by Principal of.	$ 7,536.74

As to Income

Life tenant becomes entitled to the entire net income from operation of the property.	$ 659.06

Audit Procedure in Connection with the Verification of an Account of Proceedings of an Executor or Trustee

By Harold T. Gates, C.P.A.

THE subject matter of my discussion is limited to the verification of a typical account of proceedings such as would be filed on behalf of an executor or a trustee. It does not include treatment of the audit of accounts of receivers, guardians or other fiduciaries. The auditor may be called upon to make such a verification by a trust company, by a firm of lawyers who may have prepared the account, or in many instances, he may be called in by an interested party such as a legatee or a beneficiary of a trust. The purpose of such an examination is to substantiate the fact that the executor or trustee has accounted for all property received by him and with which he stood charged and for his activities in connection with the conservation and distribution of these assets. Also, to determine that he has properly charged himself with all the income collected or collectible and that disbursements made from both principal and income cash are properly and correctly stated in the account. Finally, to ascertain that assets remaining on hand are properly stated as to quantity and value and that the account correctly shows any balance of any income undistributed at the date of rendering of the account.

Before starting the actual verification of the account the will or deed of trust should be read very carefully and an analytical digest made. In the case of a will, particular attention should be paid to the listing of the names and relationship of legatees, distributees and beneficiaries of income under the will and the nature and amount of any legacies or bequests. In this manner a preliminary view will be obtained of the disposition of the assets prescribed by the testator. In the case of a deed of trust it may be that a list of the assets constituting the trust or at any rate the amount of the fund constituting the capital of the trust will be stated therein.

The next step recommended would be a preliminary examination of federal and state estate tax returns. Inquiry should be made at this time as to whether final determination of the tax has been made. If so, quantities and values as stated in the state estate tax return will ordinarily form the basis of subsequent verification of the opening inventory as stated in the account of proceedings. If final determination has not been made, or if the accounting under question is that of a trustee, the auditor should satisfy himself as to valuation of the assets through ordinary audit procedure. In using estate tax data it should be borne in mind that certain items will be included in the estate tax returns which may not be required to be listed in the account to the surrogate. For instance, real estate is included in arriving at the gross estate for estate tax purposes, whereas in filing an account for an executor real estate will

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not be included in the account unless and until sold and will then be listed at the amount of the proceeds of sale. Furthermore, in the federal estate tax return, gifts made by the deceased five years prior to the date of his death are listed and proof is required to be furnished that such gifts were not made in contemplation of death.

Since the New York State estate tax procedure requires that the authorities be notified as to any change made upon examination of the federal return, the auditor may find that the federal return furnishes better substantiation as to quantities and valuations to be carried in the account of proceedings than does the state return and may indicate the possibility of adjustment and of possible additional state tax assessments.

Let us assume that an account of proceedings has been prepared from records kept by the fiduciary and is submitted for your verification. Audit procedure may well follow the order in which the account of proceedings is summarized. In the case of an estate, comparison should be made between the assets as stated in the federal estate tax return and those disclosed by the opening inventory to see that both quantities and valuations are identical. In the case of accounting for a testamentary trust or a trust created intervivos, valuation would have to be made as of the date of the creation of the trust by ordinary audit methods. Advice slips or statements from brokers and bankers and paid checks should be examined in substantiation of assets acquired by purchase and substantiating documents should be reviewed in support of any acquired through substitution or exchange such as the accepting of a new issue of bond in place of bonds which may have matured. Broker's advices or other substantiating documents should be examined in verification of the proceeds of sale of stocks, bonds, or other personal property. In the form of accounts of proceedings used in New York County, sales and exchanges of assets are shown on three separate schedules, one of which shows items sold on a profit causing an increase in corpus, another showing items sold, redeemed, or exchanged, which result in neither profit or loss and finally a third schedule on which such items are listed whereas a result of the sale or exchange a loss is sustained causing a decrease in the corpus of the estate. Unless specific authority is given in a will or deed of trust granting the executor or trustee discretion in the matter of investments, securities held or acquired should meet the test of being "legals" for savings banks as defined under Section 239 of the Banking Law.

After the verification of the opening inventory and the examination of documents supporting the changes therein has been completed, the auditor should trace the changes from the opening inventory both as to quantities and cost through the relative schedules of the account and arrive at quantities and values shown in the closing inventory. The ordinary account of proceedings will extend over a period of at least a year. In many instances, several years may be covered. In cases where a considerable number of items are involved, it may be well for the auditor to prepare a work sheet listing quantities, description and valuation as stated in the opening inventory and in parallel columns show (1) any additions thereto by purchase or exchange, listing both quantities and cost and (2) similar details as to assets sold, exchanged or otherwise disposed of. Thus, by the process of addition and subtraction, he should arrive at the inventory remaining on hand at the date of the accounting. In the course of the preparation of such a work sheet the schedules involved should be analyzed as to their effect upon principal cash. In other words assets are ordinarily acquired through the disbursement of principal cash. Assets sold result in the receipt of principal cash for the entire proceeds of the sale. Where assets are exchanged they have no effect upon principal cash.

If the schedules of principal expenses and legacies be similarly analyzed, it is possible, starting with the balance of principal cash on hand at the date of death, to work through the accounting schedules and prove the balance of principal cash on hand at the date of accounting.

In order to illustrate the procedure above outlined, I am submitting a set of schedules prepared from the transactions used by Mr. Briloff* in his discussion of an accounting system and a set of working papers analyzing the effect of the respective schedules upon the opening inventory including principal cash and upon the income cash and the corpus of the estate. Explanatory notes as to the use and preparation of these schedules are submitted at the bottom of certain of the work sheets.

Checks and supporting data should be examined to substantiate disbursement for funeral and administration expenses paid. The auditor should also see that any limitation placed upon funeral expenses in the will have been observed. Particular consideration should be given to the proprietry of the charges for administration expenses. Debts of the decedent paid by the executor should be supported by statements of the creditors. Preferably, all claims should be "verified", that is, should be accompanied by an affidavit of the creditor to the effect that the statement submitted constitutes a just and true claim against the decedent and that to the best of his knowledge and belief there is no counter or off-setting claim against the amount stated. Federal and State income tax returns which have been prepared on behalf of the decedent or estate or trust, should be examined in order that the auditor may satisfy himself that there has not been an overpayment or that there is no possibility of additional assessment being received. However, if final determination of these taxes has been made and agreements signed, the auditor would be relieved of the necessity of further investigation. Paid checks should be examined with respect to cash legacies paid or advances made thereon. Such payments should also be compared by the auditor with the list of legacies prepared as a part of his digest of the will. Comparison should also be made with the schedule of legacies submitted in the account of proceedings. Investigation should be made to ascertain whether all specific legacies have been delivered or whether any remain listed in the closing inventory available for delivery.

Unless otherwise provided in a will, federal and state estate taxes are, by statute, chargeable, prorata against the legatees. It is the privilege of an executor to ask for a prompt audit of all returns. The auditor should ascertain whether a final determination has been made and, if allocation has been made, he should verify the computation of such allocation. If final determination has not been made, the auditor should satisfy himself as to the correctness of the amount paid or to be reserved. If questions of valuation remain open the auditor should make a reservation to that effect in his report.

As previously stated, realty would not appear in the account of an executor except in the event of a sale. The proceeds of the sale of the realty would then be verified through examination of the contract of sale and verification of the receipt of cash and of a mortgage, if any. When realty has been placed in trust, deeds should be subjected to customary audit inspection to ascertain that the equitable title has actually been placed in the trustees.

Verification of income follows usual audit procedure. Particular attention should be given to the ascertainment that income has been properly apportioned from the date of death or acquisition to the date of disposal or maturity of the estate from which the income is derived. In the case of interest from

* See article by Mr. Abraham Briloff on page 582.

bonds and mortgages the auditor should verify that income is received at the rate specified in the bond or in the mortgage. He should also, of course, verify any changes made through exchange of one issue of bonds for another or through change of rate in interest on mortgages. Interest accrued up to and including the date of death of a decedent is includable as principal of the estate. Interest earned subsequent to the date of death is income.

Dividends received in the ordinary course of the administration of the estate, if received from stocks listed in a recognized exchange, may be verified in the customary manner through examination of published dividend reports such as those furnished by Poor's, Fitch's and dividend records. If unlisted, it may be necessary to communicate directly with the company or its disbursing agent.

There is some question at the present time as to proper treatment of dividends declared prior to the date of death of decedent but collected subsequent thereto. The ruling of one surrogate in New York State has been to the effect that owner of record at the date of declaration of the dividend is entitled to the dividend, while another surrogate holds that the owner at the date of record should be deemed to be the owner of the stock. In any event dividends are not apportioned at the date of death but become as a whole either principal or income. This rule holds true with the exception of certain guaranteed dividends. On the other hand interest accrued up to and including the date of death is deemed to be principal whereas that portion accrued subsequent to the date of death is included in the income. Under Section 17A of the personal property law, stock dividends are deemed to belong to principal unless otherwise specified in the will or deed of trust.

In case realty has been made the subject of a trust, rentals may be verified through customary examination of rent rolls or statement from collecting agents. Rent due and payable up to and including the date of death of a decedent constitutes principal. Rent coming due and payable subsequent thereto should be included as income.

Paid checks and other supporting documents should be examined in substantiation of payments made for administration expenses claimed to be chargeable against income. Particular attention should be paid to the propriety of such charges. In other words, such expenditures should have been made in connection with the collection of your production of income.

Income distributions made to beneficiaries should be verified through examination of paid checks and the auditor should ascertain that such distributions have been made in accordance with the provisions of the will or of the deed of trust.

Assets remaining on hand and income undistributed may be verified through usual audit procedure. Bank balances should be confirmed and reconciled with the balance of principal and income cash as shown in the account. Other assets remaining on hand should be verified by physical inspection or by confirmation with the custodian.

Commissions payable to executors and trustees have been fixed in the State of New York under the Surrogate's Court Act. However, in filing an account of procedure, the surrogate is the final arbitrator as to the amount which will be allowed. However, as part of the account estimated is submitted as to the amount of commissions due to the executors and trustees as to principal and income, the auditor should, to the best of his ability satisfy himself as to the correctness or otherwise of these estimates. Recent very important changes in the method of computation of commissions will be explained in detail by our Chairman, Mr. Saxe.

In conclusion, gentlemen, may I thank you for your attention and inter-

est in the material which I have presented to you here this evening. I hope you have found that the major features of the audit of an account to the Surrogate have been covered. If perchance some important points have been overlooked, I will indeed appreciate having them brought to my attention.

SCHEDULE A—Inventory

Face or No. of Shares	Description	Feb. 1, 1945 Inventory Value
Bonds:		
10M	XYZ Bonds, 5 pct M & N 1 @ 110	$11,000.00
	Accrued int. on above Nov. 1 to Feb. 1	125.00
Stocks:		
250 shares	DEF Stock @ 60	15,000.00
100 shares	ABC Stock @ 50	5,000.00
Notes:		
1/10/45	S. J. Thomas, non-interest bearing	500.00
	Cash in National City	10,000.00
		$41,625.00

SCHEDULE A-1—Increment

Date	Description	Proceeds	Inventory Value	Increase
1945				
February 7	Sold ABC Stock @ 53	$5,300.00	$5,000.00	$300.00

SCHEDULE A-2—Income Collected

1945			
February 9	Collected dividends February 2 on DEF stock at 1.00 per share	$250.00	
February 16	Collected interest on 10M XYZ Bonds February 1 to date	20.83	$270.83

SCHEDULE A-3—Assets Collected at Par

Date	Description	Amount Collected
1945		
February 8	S. J. Thomas Note	$500.00

SCHEDULE B—Decreases

Date	Description	Proceeds of sale	Inventory	Decrease
1945				
February 16	Sold 10M XYZ 5% Bonds	$10,800.00	$11,000.00	$200.00
	Accrued Interest thereon Nov. 1, 1944 to Feb. 1, 1945	125.00	125.00	—
		$10,925.00	$11,125.00	$200.00

SCHEDULE G—New Investments

Date	Description	Amount
1945		
February 28	Purchased 5M USA Treasury 2½% Bonds...	$5,050.00

SCHEDULE C-2—Expenses Charged to Income

Date	Description	Amount
1945		
February 28	Accrued Interest paid on 5M U.S.A. Treasury 2½% Bonds through February 28..........	$10.00

SCHEDULE E—Payments to Creditors

Date	Name of Individual	Nature of Claim	Amount
1945			
Feb. 10	Dr. Sidney Strong	Professional services during last illness	$100.00
Feb. 11	Lord & Taylor	Purchases by deceased.........	55.00
Feb. 18	Coll. of Int. Rev.	Final payment 1944 income tax of deceased	380.00
Feb. 22	N. Y. Telephone Co.	Telephone bill month of January	14.50
			$549.50

SCHEDULE C—Funeral—Administration Expenses

Date	Payee	Description	Amount
1945			
Feb. 14	Surrogate's Clerk	Copies of letters testamentary...	$ 3.00
Feb. 15	Campbell Funeral Parlor	Funeral Services	625.00
			$628.00

SCHEDULE F—Payments to Legatees

Date	Name of Legatee	Description	Amount
1945			
Feb. 24	Tribune Fresh Air Fund	Cash	$1,000.00

SCHEDULE H—Inventory as to Principal

Par Value	Description	Cost or Inventory Value
	5M USA Treasury 2½% Bonds.......	$ 5,050.00
	250 Shares DEF Stock................	15,000.00
$19,497.50	Cash Principal	19,497.50
		$39,547.50

SCHEDULE H-1—Undistributed Income Balance

Description	Value
Income cash on hand..............	$260.83

INCOME COLLECTED

1945		1946		Total Income
Date	Amount	Date	Amount	Collected
2/9/45	$250.00			$250.00

Explanation:

This may be a 7 column work sheet and should be stapled to the "Analysis of Changes in Assets" at the point indicated and postings of income collected made opposite the description of the asset from which received. After postings are completed the income may be totaled and verified against the time during which the asset had been held.

(Clip Income Information Sheet here)

ANALYSIS OF CHANGES IN ASSETS AND PROOF OF CLOSING INVENTORIES

No. of Shares or Par Value	Description	Inventory Value Feb. 1, 1945	Assets Acquired: Date	Assets Acquired: Shares or par value	Assets Acquired: Cost	Assets Disposed of: Date	Assets Disposed of: Shares or Par value	Assets Disposed of: Cost of 2/1 Inventory Value	Increase	Decrease	Inventory per Account: No. of shares or Par Value	Inventory per Account: Cost or 2/1 Inventory Value
Bonds:												
10M	XYZ 5% bonds, int. payable M & N @ 110...	$11,000.00				2/16/45	10M	$11,000.00		$200.00	-0-	
	Accrual interest thereon Nov. 1 to Feb. 1.....	125.00				2/16/45		125.00			-0-	
	Acquired:											
	U.S.A. Treasury 2½% bonds—accrued interest		2/28/45	5M	$ 5,050.00						5M	$ 5,050.00
Stocks:												
250 shs.	DEF stock @ 60........	$15,000.00									250 shs.	15,000.00
100 shs.	ABC stock @ 50........	5,000.00				2/7/45	100 shs.	5,000.00	$300.00			
Other Assets:												
$500.00	Note of S. J. Thomas non-interest bearing—Dated Jan. 1	500.00				2/8/45		500.00				
	Totals other than cash...	$31,625.00			$ 5,050.00			$16,625.00	$300.00	$200.00		$20,050.00
Principal Cash:												
Balance 2/1/45	....	10,000.00			16,725.00			7,227.50				19,497.50
		$41,625.00			$21,775.00			$23,852.50	$300.00	$200.00		$39,547.50

PRINCIPAL CASH

Dr.		Cr.	
Sch. A	$10,000.00	Sch. E	$ 549.50
Sch. A-1	5,300.00	Sch. C	628.00
Sch. A-3	500.00	Sch. F	1,000.00
Sch. B	10,925.00	Sch. G	5,050.00
		Balance	19,497.50
	$26,725.00		$26,725.00
Bal. 2/28/45	$19,497.50		

INCOME CASH

Dr.		Cr.	
Sch. A-2	$ 270.83	Sch. C-2	$ 10.00
		Balance	260.83
	$ 270.83		$ 270.83
Bal. 2/28/45	$ 260.83		

CORPUS

Dr.			Cr.	
Decrease	Sch. B.	$ 200.00	2/1/45 Bal.	$41,625.00
F & A Exp.	Sch. C.	628.00	Sch. A	300.00
Claims	Sch. E.	549.50		
Legacy	Sch. F.	1,000.00		
Balance		39,547.50		
		$41,925.00		$41,925.00
			Balance	$39,547.50

Explanation:

The above analyses are obtained through analysis of the respective schedules as to their effect on principal cash, income cash and the corpus or principal of the estate.

Trustees' Commissions Under the New York Law

By Emanuel Saxe, C.P.A.

The Applicable Statutes

THE New York law regulating trustees' commissions was completely revolutionized by the enactment of Chapters 694 and 695 of the Laws of 1943 (effective September 1, 1943), despite the vigorous opposition of the New York Surrogates' Association and various Bar associations. A year of experience under the new law, with its entirely new approach to the problems of the compensation of trustees, resulted in the passage of needed amendatory legislation (Chapters 138, 139 and 141 of the laws of 1944, effective March 13, 1944) to cure certain previously noted shortcomings and defects. Even so, the present law is far from perfect.

Testamentary Trustees

The present section 285-a of the Surrogate's Court Act, as thus amended, prescribes the manner of computing the commissions of testamentary trustees, including executors acting as trustees, and executors acting as fiduciaries for the benefit of a life tenant.

Trustees of an Expressed Trust

Section 1548 of the Civil Practice Act, as thus amended, deals with the commissions due the trustee of an expressed *inter vivos* trust.

The New Annual Commissions
Income Commissions

A trustee is now authorized by law (S.C.A., sec. 285-a, subd. 1-A*) to retain the following income commissions, annually:

6% on the first $2,000 of income collected in each year;

3% on the next $10,000 of income collected in each year; and

2% on the balance of income collected in each year.

In the determination of *income* commissions, the *Swartz-Schinasi* rule (*Matter of Schinasi,* 277 N. Y. 252—1938) authorizing the computation of income commissions on the basis of *gross* rents, has been continued.

Failure on the part of a trustee to retain commissions at the time he became entitled thereto does not operate as a waiver of any such commissions, provided that income for that particular year remains undistributed and available for the purpose. (S.C.A., Sec. 285-a, subd. 1-C; *Estate of Benj. Garfunkel,* N.Y.L.J., April 27, 1944, opinion by Foley, S.)

Principal Commissions

The law with respect to principal

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* All "subdivision" references herein made are to Section 285-a of the Surrogates Court Act. Parallel references will be found in section 1548 of the Civil Practice Act.

commissions has been completely changed. Whereas the old law made the amount of the trustee's commissions dependent upon the amount of principal actually administered (i.e., received and paid or delivered) and conditioned the right thereto upon the rendition and settlement of his account, the new act (S.C.A., Sec. 285-a, subd. 1-B) fixes the trustee's regular annual principal commissions at 110% of the income commissions for each year. As a result of this change, the large body of case law developed under the old law has been completely suspended and rendered obsolete.

A limitation upon this general rule of computation appears in subdivision 6 of the same section, which provides that "the net amount of rents collected and not the gross amount shall be used" in computing principal commissions. Viewed in the light of the history of the *Swartz-Schinasi* rule (*supra*) the term "net....rents collected" here specified is undoubtedly synonymous with "net rents" as defined by Surrogate Delehanty in *Matter of Schinasi* (161 Misc. 636, 643—1936; aff'd., 252 A.D. 82, 83-84—1937). It thus becomes necessary under the language of the statute to make a preliminary, separate (theoretical) computation of principal commissions based on net rentals, in order to comply with this limitation.

Where principal receiving commissions (and, in a proper case, paying commissions on partial distributions of principal) have already been received by a trustee under the old law (whether before or after September 1, 1943) no further annual principal commissions may be taken by him under the new law until the amount theretofore received has been fully absorbed by the annual allowance for commissions under the new method of computation, based on income received on and after September 1, 1943. A computation fully illustrative of this point is presented in *Matter of Hurlbut* (180 Misc. 681,—1943).

It should also be noted that, although principal paying commissions on realty devised in trust were denied to trustees under the old law (*Matter of Miller*, 257 N. Y. 349,—1931; *Matter of Jones*, 136 Misc. 122,—1930), and the new act has been construed as not modifying this rule (*Matter of McGinnis*, 181 Misc. 207,—1943) nevertheless, a trustee will, under the new law, receive annual principal commissions, equivalent to 110% of the net income from rents of real property.

Annual Rest Required

As a condition precedent to the retention of both the annual principal and income commissions, the 1944 amendment (S.C.A., sec. 285-a, subd. 1-C) requires the rendition of a statement showing the income collected and the computation of all commissions retained. This statement must be furnished to all income beneficiaries and to such remaindermen as shall have requested it. It must also be made available, upon request, to all other remaindermen who shall not have theretofore requested and received it.

No Retroactivity in Computation of Annual Commissions

The new law will not be retroactively applied. Neither the annual income commissions nor the annual principal commissions may be based on income earned prior to September 1, 1943. (*Matter of Hurlbut, supra; Matter of Pessano*, 181 Misc. 295,—1944; *Estate of Jennie W. Cushing*, N.Y.L.J., April 6, 1944, page 1344, opinion by Foley, S.; *Estate of Benj. Garfunkel, supra*).

Testamentary Trustee's Former Receiving Commission Preserved Until March 31, 1946

As pointed out in the paragraph immediatley preceding, the clear legislative intent was to apply the new rates of principal commissions prospectively, only, and beginning September 1, 1943.

However, to recify a patent injustice, trustees of testamentary trusts which

were established before September 1, 1943, who have not received the principal receiving commission under the old law are now permitted to account, apply for and receive such receiving commission, provided that the decree awarding it is dated on or before March 31, 1946. (S.C.A., 285-a, subd. 2, as amended by Laws of 1944, Ch. 138).

It should be noted that there is no parallel provision in section 1548 of the Civil Practice Act, dealing with the compensation of trustees of *inter vivos* trusts.

The subsequent retention of annual principal commissions under the new law is limited in the same manner as if such receiving commissions under the old law had actually been withdrawn prior to September 1, 1943.

Multiple Commissions

If there be more than one fiduciary, the new law provides that "if the gross value of the principal of the trust amounts to one hundred thousand dollars or more at the time of the receipt thereof by the trustee or the last judicial settlement of the trustee's account" each shall be entitled to one full commission, "unless there shall be more than three, in which case the compensation to which three would be entitled shall be apportioned among them according to the services rendered by them respectively." (S.C.A., Sec. 285-a, subd. 5; *Matter of Pessano, supra*).

This language has been judicially construed to mean that the one hundred thousand dollar test will be applied to the amount with which the trustee is chargeable; i.e., if an initial accounting, the amount at the time of receipt; if a subsequent accounting, the value at the conclusion of the prior accounting period. (*Matter of Ryley,* 180 Misc. 696 at page 698,—1943; see, also, *Matter of Lewin* (Sariyan), N.Y.Cty., Sup. Ct., Sp. Term, Part 1, N.Y.L.J., October 7, 1944, opinion by Peck, J., involving the commissions due the committee of an incompetent, for an analogous case).

However, Surrogate Foley in an article entitled *"Inheritance Law Changes* (Part III)" appearing in the New York Law Journal on July 7, 1944, said, "The proper test for multiple commissions should be the value of the assets at the time of the withdrawal of commissions rather than its value at some other date."

Minimum (Distribution) Commissions

Full Rates

The following minimum rates of principal commissions are prescribed in subdivision 3 of section 285-a, for testamentary trustees acting at a time of distribution of principal:

5% on the first $2,000 of principal distributed;

2½% on the net $20,000 of principal distributed; and

2% on the balance of principal distributed.

In making any computation under this paragraph, the value of any real or personal property shall be considered as money.

Half Rates

If such distribution be made within five years from the date of the trustee's qualification, the rates of minimum principal commissions are reduced by one-half (*Estate of Rose L. Gazan,* N.Y.L.J., Nov. 13, 1943, page 1320, opinion by Foley, S.).

The five year period is measured from the date of the qualification of the trustee, i.e., the date of issuance of his letters, to the date of actual distribution of the fund. (*Matter of Reckford,* 181 Misc. 211,—1944).

Prior distributions to be taken into account

If any previous distributions of principal have been made, they are also to be taken into account in this computation. (S.C.A., sec. 285-a, subd. 3).

Any and all previous principal commission allowances,—such as principal

receiving and paying commissions withdrawn under the old act, principal receiving commissions allowed under subdivision 2 of the new act, and the annual principal commissions under subdivision 1-B of the new act must be deducted from the minimum allowance permitted in subdivision 3.

A previously renounced receiving commission is treated as if it had been actually allowed and paid for purposes of computing the minimum distribution commissions. (*Matter of Henry Evans,* N.Y.L.J., June 12, 1945, page 2254, opinion by Foley, S.; *Matter of Erickson,* 184 M. 830,—1945).

It may be noted parenthetically that where a principal receiving commission has previously been received, a possible effect of the minimum commission rule may be to pay a sum which is greater than one-half of the commission at the minimum rates, if the receiving commission theretofore received was computed under an old law where the rates were lower. (*Matter of Stone,* 181 M. 340,—1944).

Final Distribution Contemplated

The leading cases which are interpretive of this subdivision unite in the acceptance of the principle that the very concept of minimum commissions indicates that it is not subject to fixation until the complete administration of the trust. (*Matter of Edwards,* 183 Misc. 1014,—1944; *Matter of Ladew,* 183 Misc. 1020,—1944).

The exercise of a power to appoint the remainderman of a trust by a testamentary direction in the will of the life beneficiary (who was the donee of the power) to the effect that the principal be held in further trust by the same trustee and another, results in two actually different trusts under two distinct instruments of trust. Unless otherwise specified by the parties, the trustee under the donor's will will be deemed to have made a final distribution within the purview of the foregoing rule. (*Matter of Culver,* N. Y. Court of Appeals,—N. Y.—, June 7, 1945; *contra*: *Matter of Ladew, supra,* and *Matter of Alexander Deutsch,* N.Y.L.J., June 3, 1944, page 2142, Surr. Ct., N.Y. Cty.).

Fractional interim distributions at a specified age and payments for administration expenses are not subject to minimum commissions. (*Matter of Edwards, supra;* also, *Estate of Salvador Rodriguez,* and *Estate of Ida K. Simonton,* N.Y.L.J., August 17, 1944, decided by Mr. Surrogate Foley, simultaneously with and on the authority of *Matter of Edwards, supra.* But see *Matter of Boettger,* 184 M. 102-1945, wherein commissions were allowed in a situation resembling an interim distribution upon a special state of facts.).

However, some earlier cases appear to have permitted minimum principal commissions on fractional parts which have become distributable under the will. (*Matter of Kelly,* N.Y.L.J., Jan. 6, 1944, page 65, Westch. Cty.; *Matter of Edward L. Miller,* N.Y.L.J., Jan. 4, 1944, N.Y. Cty., opinion by Foley, S.).

Further evidence of the impossibility of construing the present form of the statute so as to permit payment of minimum commissions upon partial distributions of principal was also discerned by Surrogate Foley in the attempt, during the 1944 legislative session, to amend this subdivision (3) "by providing for the payment of minimum principal commissions to a trustee acting at a time of distribution, 'whether such distribution be partial or complete'. The trustee was to be paid at the specified rates on the amounts of principal 'at any time by him distributed' ". (*Matter of Edwards, supra*). The bill (Assembly Int. No. 571, Print No. 2362) was vetoed by Governor Dewey. Said the Surrogate in connection with this bill, "In order to read the statute as applicable to partial distributions, it was necessary not only to insert additional express language; it became necessary to completely revise it and to eliminate matter contradictory

of such an interpretation" (*Matter of Edwards, supra*).

Realty Held in Trust Excluded from the Base

In applying the minimum commission rule the principal distributed by the fiduciary comprises the base for the computation. Since realty held in trust vests in the remainderman by operation of law, the trustee does not distribute it. (*Matter of Miller, supra; Matter of Jones, supra*). Therefore, though formerly subject to receiving commission under the old law, it is not now included in the base for minimum commissions. (*Matter of McGinns, supra*). A bill to abrogate the effect of this rule, introduced in the 1944 Legislature (Assembly Int. No. 571, Print No. 2362) was vetoed by the Governor.

The language of subdivision 3 to the effect that real property shall be considered as money in making computation under this paragraph "may have been intended to cover those few instances in which by reason of exercise of a power of sale or by reason of condemnation of realty or by reason of the special terms of a will the trustee has basis for claiming that he distributed the realty." (*Matter of McGinnis, supra*).

Maximum Commissions

The 1944 amendment substituted a new subdivision 9 in section 285-a of the Surrogate's Court Act, and thus cured a serious defect in the original act, namely, the failure to place a ceiling upon the total amount of principal commissions received both before and after September 1, 1943, in cases where the life of the trust is of long duration.

Rates

By its terms, the total principal commissions of a sole trustee, received by him both before and after September 1, 1943, shall not exceed 6% of the principal of the trust received by such trustee (that is, the principal received upon his qualification, plus any principal subsequently added, but not including any increase—whether realized or unrealized—in the value of the assets comprising the trust), valued at the time of the receipt thereof. (*Estate of Wm. H. Walker,* N.Y.L.J., April 13, 1945, opinion by Foley, S.).

In the event that at any time there are, or have been, two trustees acting together as co-trustees of a trust, the principal commissions of any such trustee shall not exceed 5% of the principal of the trust received by such trustee, valued at the time of the receipt thereof.

For three or more trustees, the limit of the principal commissions of each is fixed at 4% of the principal of the trust, etc.

Although the limitations (with respect to multiple commissions) contained in subdivision 5 of the section are directed to be applied independently of, and without regard to, the provisions of this subdivision, no trustee may receive principal commissions in excess of the limit prescribed by this section.

Incomplete Administrations

Death of Fiduciary

In the event of the death of a trustee, commissions are allowable to his estate for services rendered by him in his fiduciary capacity during his lifetime, in the exercise of the discretion of the surrogate and not as a matter of statutory right (*Matter of Barker,* 230 N.Y. 364,—1921; *Matter of Bushe,* 227 N.Y. 85,—1919).

Although in these cases the court is not bound by the provisions of S.C.A. section 285-a (*Matter of McGinnis, supra*), the surrogates have adopted the policy of compensating the estates of deceased trustees under a method adapted from the minimum commission rule. They have allowed a receiving commission upon all assets received and a paying commission upon all distributions actually made, each computed at one-half the rates specified in S.C.A.. section 285-a, subd. 3 (*Matter of Reckford, supra; Matter of Ed-*

wards, supra; Matter of McGinnis, supra; Matter of Henry C. Opitz, N.Y.L.J., June 21, 1945, opinion by Foley, S.; *Matter of McMurtry,* N.Y. L.J., Dec. 30, 1944; *Matter of Hastings,* N.Y.L.J., Oct. 25, 1944, per Foley S.; *Matter of Fry* (Hale Trust), *Matter of Fry* (Fry Trust), and *Matter of Rodriguez,* all N.Y.L.J., Aug. 17, 1944, all per Foley, S.; *Estate of Gustavus Sidenberg,* N.Y.L.J., Mar. 3, 1944, page 848, per Foley, S.).

When the trustee before his death has already received a receiving commission at the rates prescribed in the former act, the court, in the exercise of its discretion will now grant an additional commission to the trustee's estate upon actual distributions made by him at one-half the rates specified for minimum commissions (*Matter of Wandling,* 181 M. 292,—1943).

Resignation of Fiduciary

In the event of the resignation of a trustee, and of the continuation of the trust administration by a successor trustee, the resigning trustee will be denied any commissions for paying over the trust corpus to the continuing trustee, although he may claim a receiving commission under the 1944 amendment. (*Estate of Jennie L. Rosenzweig,* N.Y.L.J., Aug. 4, 1945, page 227, opinion by Delehanty, S.).

Successive Life Estates

No commissions will be paid a trustee for turning over to himself that part of the trust fund which is to be held in further trust, after the death of a primary life tenant. (*Matter of Reckford, supra,* and authorities therein cited; *Estate of Cornelia D. Earle,* N.Y.L.J., Feb. 3, 1944, opinion by Foley, S.).

Perpetual Charitable Trusts

The present law provides that a trustee of a perpetual charitable trust shall receive his regular annual commissions on principal and income until the termination of all preceding life interests therein. Thereafter, he shall be entitled to income commissions at the rate of 5% of income collected, and to no principal commissions (S.C.A., sec. 285-a, subd. 4).

Where there is no preceding life estate and the trust is a charitable trust in perpetuity, the only commissions allowable are the 5% income commissions (*Matter of Belknap,* 50 N.Y.S. (2d) 228,—1944; *Matter of Evans,* N.Y.L.J., June 12, 1945, opinion by Foley, S.). Nor may any receiving commissions under sec. 285-a, subd. 2, as amended, be allowed the trustee of such a trust (*Matter of Belknap, supra*).

Miscellaneous Provisions

Real Estate Management Fee

The 5% fee for collecting the rents of and managing real property is continued (S.C.A., sec. 285-a, subd. 6). Only one such allowance is permitted regardless of the number of trustees serving, and any management fee paid by a trustee to an agent must come out of this allowance. (*Matter of Althouse,* 122 Misc. 279,—1924; *Matter of Byrnes,* 159 Misc. 302,—1936).

Renunciation of Specific Compensation

Subdivision 7 states that where the will provides a specific compensation to a testamentary trustee, he shall not be entitled to any other allowance for his services unless the specific compensation be renounced by him by a written instrument filed with the surrogate within four months from the date of filing his oath of office.

Reimbursement of Trustee's Expenses

Subdivision 8 continues the provision previously contained in the preamble of former section 285, by which a trustee is allowed his just, reasonable and necessary expenses actually paid by him and such compensation for legal services in connection with his official duties as the surrogate deems just and reasonable.

Partnership or Corporation? Tax and Other Considerations

By Augustus Morris

This is the text of an address before a meeting of the Committee on Post-Admission Legal Education of the Association of the Bar of the City of New York on November 16, 1945.

LET me start by saying that it cannot be said categorically that the corporate, partnership or sole proprietorship form of doing business is the best form. Final decision with respect to a particular individual must depend from a legal aspect upon his special needs, and from a tax viewpoint partly on estimates of future income and the necessity for distributing that income, partly on prognostications of congressional and judicial tax action, partly on guesses as to future economic conditions.

However, generally speaking, there have been certain rather clear trends in the selection of a business form. One of the prime factors which has influenced this choice has been the comparative tax burdens of each form. During the pre-war period with tax rates at a relatively low level, the corporate form was generally used. Even if there was a slight tax disadvantage, it was outweighed by other advantages which the corporate form offers businessmen. However, the advent of the heavy excess profits tax resulted in a breakup of smaller corporations and a resort to the partnership or individual proprietorship form in an effort to avoid this war tax. The repeal of the excess profits tax will probably inaugurate a rush back to the corporate business form. In addition, there are several tax proposals presented to Congress favorable to the corporation which have a strong chance of enactment. These would permit corporations a tax credit for dividends paid and allow smaller corporations to report as though they were unincorporated entities. It may be of interest to know that some of the new questions on 1945 Form 1120 were added to obtain some additional information on the advisability of allowing corporations to report as partnerships.

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But the choice of a business form cannot be made on the basis of any general trend. It must rest solely on the special (and often peculiar) facts of the particular business. It may be advisable for an individual business to go counter to any general trend.

Obviously, the advantages and disadvantages of a partnership or a corporation can be of interest only to those businesses which have a freedom of choice available to them. Larger businesses which must resort to the open market for funds have no choice but to use the corporate form regardless of its relative advantage or disadvantage over other forms of business enterprise. However, for the majority of American businesses, at least in numbers, it is usually possible to adopt any available business form.

Legal Aspects

I certainly have no intention of explaining the legal aspects to this distinguished group of members of the bar. However, I would like to review some of the legal aspects in the light of their practical application.

Limited Liability

The greatest advantage a corporation possesses is its limited liability feature—the ability of a corporation to shield the stockholder from any losses other than his capital contributions to the corporation. In many cases this can be the determining factor in the selection of the business form. However, it is well to bear in mind that in certain circumstances this limited liability feature may not be in practice as important as it is generally thought to be. Most of the unforeseeable disasters which may lead to bankruptcy, such as fire, theft, collision, hurricane, etc., may be protected against by the use of insurance. In addition, particularly in the case of the small business, the owners may very often have their own entire personal fortunes invested in the corporation as capital—sudden failure would deprive them of all their assets regardless of the "legal protection". Thirdly, banks and other creditors may often require the personal endorsement of stockholders of closed corporations.

Limited liability, moreover, is not always restricted to corporations. A limited partnership can often yield the same benefits, at least as far as the limited partners are concerned.

Length of Life

A close second to limited liability as the greatest advantage of the corporation is its continuous existence. Regardless of changes in ownership, the corporation can carry on as a separate legal entity until the life period stated in its charter runs out. This period may range from a specified number of years to perpetuity, depending on the law of the state in which the corporation is formed.

In contrast, the life of a partnership is subject to many hazards, any one of which may effectively put an end to its business existence.

Transferring Interests

Another marked legal distinction between a corporation and other forms of doing business is the flexibility of ownership possible without any change in management. In other words, the possibility of buying and selling shares of stock permits a ready transfer of ownership which is not available in the partnership form of business. However, here again the smaller the corporation, the more nearly management and ownership tend to merge, so that for a corporation which is in effect a two-man partnership, there would be in practice no more ease of changing ownership than if they had operated as a partnership.

This ease of transferring fractional interests makes the corporate form admirably suited for making gifts to members of the family as a means of reducing future estate taxes.

Sharing Profits

Partnership profits may be distributed in accordance with the ratio set in the partnership agreement. It is not necessary that this proportionate distribution bear any relation to the amounts of capital distributed by either partner. The ratios may be purely arbitrary. Corporate profits, on the other hand, must be distributed strictly in accordance with the stockholder's proportionate ownership of the particular kind of stock in which dividend is declared.

Formalities Required

As a practical matter, there is very little difference in the formalities required to start either an individual proprietorship, a partnership, or a corporation. While, technically, articles of a corporation must be drawn up for a corporation, these, as we all recognize, are routine formalities which will rarely

affect a choice of business form. Furthermore, the amount of financial reports and tax returns which must be filed by a corporation, partnership or individual proprietorship is again quite similar. While a corporation must file a franchise tax return, a partnership or individual has to file an unincorporated business tax return. Thus, the formalities and returns required are seldom factors in deciding the type of business enterprise to select.

Summary

As far as the legal consequences are concerned, the general answer for most businessmen would probably be the corporate form. However, it is chiefly (again speaking in general terms) the tax consequenses which may make it too expensive to use the corporate form.

Tax Aspects

All of the differences which crop up in a comparison between the taxes to be paid by the two forms of doing business stem from two fundamental differences in their tax treatment:

First, corporations are not taxed at the same rates as an individual. A corporation is subject to a normal tax and surtax ranging from 21% to 38% (references being made to 1946 rates). On the other hand, an individual is subject to a normal tax and surtax ranging from a low of 19% to a high of 86.45%, with an overall maximum of 85½%.

Second, a partnership is considered to be inseparable from its partners. If a partnership has a profit, the partners are treated as having earned their proportionate share of that profit. If the partnership loses money, the partners are likewise considered to have sustained their share of the loss. A corporation, on the other hand, is a person completely separate from its stockholders. Even though the stockholder is the complete owner of the corporation, he is not immediately affected by corporate profits or losses. If the corporation has a profit, the stockholder does not have to include any portion of the profit in his personal tax return. It is only when the corporation pays out some of its profits that the stockholders are affected taxwise.

The double taxation of corporate income, the differences in treatment of partners and working stockholders for payroll tax purposes, the taxation of corporate tax-exempt income, etc., are direct outgrowths of this second fundamental difference.

Comparison of Individual and Corporate Rates

Without the double tax involved when a corporation distributes dividends, the corporate income tax is lower than the income tax imposed on an individual earning the same income (except for income of less than $4,000). For example, under the 1946 rates, as provided in the Revenue Act just enacted:

Normal Tax and Surtax Net Income	Tax as Individual	Tax as Corporation	Savings as Corporation
$ 20,000	$ 6,897	$ 4,500	$ 2,397
50,000	25,479	19,000	6,479
100,000	63,954	38,000	25,954
200,000	148,979	76,000	72,979

There may be even a further saving for a corporation. The corporate profit is calculated after deducting the salaries of the stockholder-employees. This profit would, as a partnership, be thrown into the higher income tax brackets of the partners.

Corporate Income Subject to Double Tax

Comparison of the tax burden on corporate and noncorporate business has little meaning without a consideration of the tax effect of distributing the profits of the owners. When dividends are paid out of profits, the corporation is not entitled to any deduction for tax purposes. At the same time, the stockholder must report the entire amount as taxable income. Thus, from a tax viewpoint, the payment of dividends is a total loss. It results in additional tax on the individual stockholder with no

saving to the corporation. Saying this another way, it results in a double taxation of corporate profits. If a corporation earns $100, it must pay a corporation tax of at least $21. If it then distributes the remaining $79 as a dividend to a stockholder who is in the 50% bracket, the stockholder would have to pay a tax of $37.53 (after the 5% tax reduction). Net effect: a total tax of $58.53 on the $100 of corporate income.

Of course, if no dividends are distributed there is no double tax (except for the possible tax on liquidation of the corporation, discussed below). If only part of the corporate income is distributed, there is a double tax on only the portion paid out as a dividend. It is therefore apparent that a careful forecast of probable dividend policy is the first step in evaluating the relative tax advantages of the corporate and noncorporate form of doing business.

Under current tax rates, where all corporate income is to be paid out as dividends, the corporate form will almost invariably be a prohibitive method of operating a business.

Double Taxation on Corporate Liquidation

As noted above, double taxation is possible even if there are no dividend payments. If the corporation dissolves, the corporate profits will be reflected in the increased value of the assets distributed to the stockholder and will result in his payment of a larger tax.

However, this element of double taxation is a minor peril compared to the double tax on dividends. It can usually be relegated to a back seat for the following reasons:

1. The tax paid by a stockholder upon dissolution is almost always a long-term capital gain subject to a maximum effective rate of 25%.

2. The stockholder has control over the liquidation of the corporation and may never liquidate. Or he may liquidate at a time when the least tax is due.

3. If the death of the stockholder occurs before liquidation, the basis of the stock will be increased to the value at the date of death. Therefore, if the corporation were dissolved at a later date there would be no double tax. The estate tax cannot be considered to result in a double tax, since it would have to be paid regardless of the form of the business, and regardless of whether the deceased's assets consist of stock or cash.

Penalizing Unreasonable Accumulation of Earnings

Since the double taxation feature of corporations arises only when dividends are paid, most closely held corporations could easily prevent this double taxation by not paying dividends. Realistically, it is usually of little consequence to the stockholders whether the cash remains in the corporation or is transferred to their personal bank accounts. However, the law recognizes this possibility. It imposes a special penalty on corporations which permit earnings and profits to accumulate so that the individual stockholders may avoid tax. The penalty is 27½% of the first $100,000 of specially defined undistributed income and 38½% of the amount in excess of $100,000. In general, the tax is based on the income subject to normal tax, reduced by the dividends paid and the federal income tax.

The practical problem for most small corporations narrows down to what is the least amount of dividends which can be declared without running afoul of this penalty. There is no rule of thumb, but here are some general guides: No dividends need be declared so long as the funds accumulated are for the reasonable current and future needs of the business. While it's not easy to determine what are the reasonable needs of a particular business, it will help to remember that it is only where the business begins to use its funds in a manner inconsistent with normal business practice that the danger of the penalty arises. Thus, if

the funds are invested in securities of outside unrelated businesses, if substantial advances are made to stockholders, or if more cash is accumulated than the amount that ordinary business prudence would require, the corporation may well be accused of accumulating earnings purely to save the stockholders from the payment of tax.

Legitimate Reasons for Accumulating Earnings

Earnings can be safely accumulated for a variety of business reasons. For instance:

1. To finance additional business.
2. As a reserve to compensate for inventory losses.
3. To procure additional property for use in the business.
4. To liquidate mortgages or other long-term indebtednesses.
5. To acquire additional machinery and equipment.
6. To replace antiquated equipment.
7. To pay dismissal wages to employees.
8. To develop new processes, products or markets.

Where the taxpayer is not a holding company but is engaged in an active business which has obvious business hazards, the courts hesitate to substitute their judgment for that of the directors as to the reasonableness of corporate accumulations. This does not mean that if a taxpayer is engaged in the active conduct of a business, he may safely ignore the penalty surtax. It merely means that the courts will take a liberal view towards the amount of earnings which may safety be retained.

Future Attitude on Accumulating Earnings

Faced with the uncertainty and challenge of the war and reconversion period, a policy of accumulating earnings was reasonable in the case of almost any operating corporation. However, with the post-war period now here, the former liberality towards accumulating earnings will undoubtedly be followed by the Treasury's clamping down heavily on corporations which fail to spend their accumulated earnings.

Recently organized corporations which will take several years to reach their stable level have little to fear from the tax on unreasonable accumulation of earnings. The law does not require any business to remain static. A corporation has the right to grow. Earnings which are plowed back into the business for this purpose will not be treated as accumulations to avoid tax on shareholders.

How Long Can Earnings Be Retained

The accumulation of earnings without penalty today does not necessarily mean that a company is merely postponing the inevitable day when those earnings will have to be distributed as dividends. Most profits of a growing or expanding business are reinvested in corporate assets such as additional plants, equipment, inventory, working capital, etc., and become for all intents and purposes the equivalent of capital. The earnings become frozen in the business and may never be distributed. Furthermore, earnings of one year may merely build up a reserve to offset losses of poor years, and in that way may never be paid out as dividends. The final possibility is that the earnings may be distributed, not as fully taxable dividends, but when the corporation is dissolved—as capital gains subject to a maximum effective tax of 25%.

Thus, a corporation can usually build up to its normal level of business activity at a lower tax cost than a similar business operated as a partnership. Of course, at the end of this growing process the corporation may be faced with the necessity of distributing a substantial portion of its current earnings, but that is usually beyond the foreseeable future. In the meantime, the corporation has been able to accumulate a substantial amount of surplus at a smaller tax expense.

Avoiding the Double Tax on Corporations

If a corporation's earnings are not withdrawn as dividends, but are used to pay expenses to corporate stockholders, the income is transferred to the stockholders as effectively as if a dividend were paid, but only one tax is incurred—the tax on the individual. Obviously, a dividend cannot be transformed into an expense merely by changing its name. But there are many payments to stockholders which represent valid business expenses to the corporation and which can be deducted. Probably the most common expense paid to a shareholder is compensation for services rendered by a stockholder who is employed by the corporation.

A stockholder who works for his own corporation has the same status as any other employee, even though he may be the sole owner of the corporation. Therefore, any payments made to stockholder-employees as wages or salaries are fully deductible in the same manner as payments to other employees. But here also the Treasury and the courts are fully aware of the tax avoidance made possible by disguising a dividend as an expense. All payments to stockholders therefore face a close scrutiny by the Treasury to make sure that they are not a cloak for dividend payments. "Salary" will not be disallowed merely because the employee is also a stockholder, but it will have to meet the test of being reasonable compensation for services actually rendered. And the test will be the more strictly applied since the employee is also a stockholder.

Salaries do not represent the sole expenses which may be paid to stockholders. Interest, rebates, commissions, royalties, etc., may be equally valid deductions despite the fact that stockholders are on the receiving end. However, the expenses must be in fact what they purport to be, and they must be "ordinary and necessary". The transaction between the stockholder and corporation will get the usual, careful going-over to which all transactions between related taxpayers are subjected.

Where profits are so small that they can provide only a reasonable compensation to stockholders or cover other expenses to stockholders, the corporate form of business gives the owners the legal advantages of a corporation without incurring any of the federal tax disadvantages. The corporation pays no income tax since all the profits are used to pay stockholder expenses. For corporations with larger income this solution is obviously not possible and is often not advisable.

Partnerships present no problem of profit withdrawal. In the division of partnership income, a partner may be allowed a "salary", interest on capital, or a bonus; but regardless of the name, the entire amount credited to the partner is treated as merely a share of the income. Since there is no employee-employer relationship between a partner and his firm, a partner is not considered to have received any salary.

Taxing Corporate Tax-Exempt Income

Since a corporation is a separate entity, dividends received from a corporation do not retain any of the characteristics of the income out of which the dividends were paid. The result is that as a conduit of profit the corporation has the effect of converting *all* types of income into fully taxable income when distributed as dividends. Thus, fully tax-exempt income, partially tax-exempt income, and capital gains and losses all become fully taxable ordinary income when the income is disbursed as dividends. The same end result is obtained where the corporate income is used to pay the salaries of stockholder-employees. The corporate income then, in effect, becomes fully taxable as salary to the stockholder-employees—regardless of whether it would otherwise have been tax-exempt in whole or in part.

Partnership income, on the other hand, does not lose any of its character-

istics by going through the partnership. The income included in the return of the partner is identical with that received by the partnership. If the partnership realizes a capital gain, the partner's share of that gain is still considered a capital gain. If certain income received by the partnership is tax-exempt, a partner need pay no tax on his share of it.

Where a business has a substantial amount of exempt income, or capital gains which must be distributed, the tax price of operating as a corporation may be very high. Tax-exempt income is usually derived from government and state obligations, but it may also be obtained from the proceeds of life insurance on the lives of officers and employees.

Personal Tax Benefit from Business Losses

Another disadvantageous result of the treatment of the corporation as a separate body, lies in the fact that if a corporation runs into hard years the corporate losses cannot be used to offset any other income which the stockholder may have. A corporate loss (except for the carry-over and carry-back provisions) is a tax waste. On the other hand, *any* losses by a partnership can be applied to reduce any other personal income of the partner.

Obviously, this distinction is important only where an individual has a source of income outside of his business. Where a business is the only income source, it makes little difference as far as the use of business losses is concerned, whether it is incorporated or unincorporated. In either case, there is no other source of income to reduce.

The ability to carry over and carry back losses has reduced the possibility of sacrificing *all* tax benefit from corporate losses.

Social Security and Unemployment Insurance Taxes

Since a working stockholder is an employee, his salary is subject to the 1% old age benefits tax plus the 3% unemployment insurance tax. Thus, each stockholder-employee adds an annual payroll tax expense which can amount to $150 (1% O.A.B., 1% withheld, 3% unemployment insurance tax on the first $3,000 of salary).

In small concerns, the fact that a stockholder is an employee may also result in imposing the 3% unemployment insurance tax on all employees. For example, if a New York corporation has two stockholder-employees and three other employees, the corporation would be covered by the state unemployment insurance tax and would be subject to the state unemployment insurance tax of 2.7% (excluding any possible merit rating refunds). The company (if all employees received over $3,000) would have to pay $405 a year unemployment insurance tax (2.7% of $15,000). If the same business were operated as a partnership, the business would be considered as having only three employees and would not be subject to unemployment insurance tax. There would be an additional saving of 2% (O.A.B. tax) of the partner's "salary", or an additional $120; a total saving of $525 a year.

But note that in making these savings certain benefits may be lost.

Payroll Tax Benefits

While a partner does not have to pay payroll taxes on any of his income, he forfeits the benefits which arise from those payments. These benefits are twofold:

1. *Unemployment insurance.* Payments in New York State range from $10 a week to $21 a week for a maximum of 26 weeks.

This represents a cushion for an employee to fall back upon when he is unable to find a job, but for most self-employed businessmen the benefit is purely theoretical.

2. *Old age benefits.* In return for paying the 1% old age benefit tax, an employee is entiled to a lifetime annuity

when he reaches 65 plus certain death benefits.

These benefits are usually the only worthwhile privileges a businessman receives by paying payroll taxes. However, in order to secure the benefits a self-employer must usually subject himself to the 3% unemployment insurance tax which he does not want. He must therefore pay 5% of his salary (up to a maximum of $3,000) as contrasted with the 1% cost to the ordinary employee. The 5% is made up of 1% contributed by the employee, 1% by the employer (himself) and 3% unemployment insurance tax.

Employee Benefit Plan

The peculiar quirk of the law which permits stockholder-employees to be treated as employees, but refuses to recognize working partners as employees, is also important if a firm is considering, or already has, a pension, profit-sharing or stock bonus plan. These plans are designed solely to benefit employees. If anyone other than an employee is covered the plan will not qualify for tax benefits. Thus, a stockholder-employee can become a beneficiary under one of these privileged forms of deferred compensation plans, but a working partner or a sole proprietor may not.

State Income and Franchise Taxes

Most states do not impose income or franchise taxes on unincorporated businesses. Even when such taxes exist, as in New York the rates are usually lower than those applicable to corporations. However, since the local taxes are deductible in arriving at the federal income tax, the gap between the state taxes imposed on corporate and noncorporate businesses will frequently narrow to the vanishing point.

The same double taxation feature applicable to corporations under the federal income tax is also true of state taxes. Thus, a state franchise or income tax is paid by the corporation on its income while dividends paid out of that same income are again subject to state income tax on the individual stockholder (if the state has an income tax). But since state rates are comparatively low, state taxes will rarely be a major consideration.

Calculating the Annual Tax Savings

Comparison of the full annual tax bill of operating a business as a corporation or an unincorporated business will usually require a computation based not only on the present year's income, dividends, and tax rates, but also based on various estimates of future income, dividend payments and tax rates. Only after that is done will a taxpayer be able to have some idea of his possible tax bill under the two forms of business.

Changing A Business Form

There are a considerable number of other tax angles which must be considered in the event that a business already operating as either a partnership or a corporation decides that the other form is more advantageous. While time allowed does not permit me to mention all of the factors involved, I can point out some of the highlights.

From Partnership to Corporation

A partnership may transfer its property to a corporation solely in return for stock without realizing any taxable gain or loss, if (a) the partners after the exchange have at least 80% of the outstanding voting stock and at least 80% of the toal number of shares of all other classes of stock of the corporation, and (b) the amount of stock and securities received by each partner is substantially in proportion to the interest he had in the property before the exchange for stock.

In most cases, these requirements are automatically met in incorporating a business, and changing from a partnership to a corporation will usually involve no tax.

Possible Change in Basis

There is one little known provision which should be watched in the incorporation of existing partnerships.

Transfer of partnership assets to a corporation is usually performed tax-free by dissolving the partnership and transferring the assets to the corporation. The corporation then carries over the basis of the assets in the hands of the partners. But here's where the catch comes in. When a partnership distributes assets in kind, the basis to the partner of each individual asset is that part of his former basis in the partnership interest which is properly allocable to the asset.

There have been no court decisions or regulations amplifying what "properly allocable" means. However, the Treasury has indicated that each asset is to bear that proportion of the partner's former basis in the firm which the value of the property transferred bears to the value of all the firm's assets as of the date of distribution. The net effect is that the total basis of the assets remains the same, but the basis of each individual asset may be changed because actual value and basis will almost never be the same. This may result in a redistribution of basis among the assets held by the corporation.

Individual proprietorships do not face this particular difficulty. The basis of each asset remains the basis for the corporation.

The Treasury has indicated that the basis of the assets would have to be adjusted regardless of whether (a) the partnership is first dissolved and the assets then transferred to the corporation, or (b) the partnership transfers its assets to the corporation in exchange for the stock of the corporation and then distributes the stock to the partners.

Here is the way the basis would be changed under the Treasury ruling, assuming that two partners had originally invested $50,000, had left in the business profits (which had been taxed to them) of $50,000, and now transfer the partnership assets to a corporation.

	Basis to partnership	Market value	% of total market value	Basis to corporation*
Inventory	$ 50,000	$ 50,000	33⅓%	$ 33,333
Fixed assets	50,000	100,000	66⅔%	66,667
Basis of both partners' interests	$100,000	$150,000	100%	$100,000

* Percent of total market value applied to basis of both partner's interests.

The result would be to penalize the formation of a corporation, since part of the basis for an item which could be used to offset current income (inventory) was decreased, while the basis of fixed assets was increased. However, in other cases the result may be favorable to the taxpayer.

If this rule is followed, there are other dangers facing taxpayers. For those who use percentage depletion, the leasehold may have a very substantial value, and a good portion of the basis would then be applied to the leasehold. This could represent a tax waste, since percentage depletion would be allowed regardless of the basis of the leasehold.

Again it is possible for the Treasury to contend that the partnership was transferring good will to the corporation and apply a certain amount of the basis against good will with the resulting loss of tax deductions. However, it is not clear whether the Treasury will go so far as to ring in good will in this connection.

Dissolving a Corporation

Unlike the transfer of assets from a partnership to a corporation, the reverse transfer results in the recognition of gain or loss regardless of how the transaction is handled. Upon the complete liquidation of a corporation, the fair market value of the property distributed is considered full payment to the stockholder for the stock relinquished to the corporation. The result may give rise to a taxable gain, either short-term (if the stock was held for not more than 6 months) or long-term (if held for more than 6 months). The amount of the gain is the difference between the fair market value of the property received and the basis of the stock in the hands of the stockholder. In most cases this basis will be the amount of money the stockholder paid into the corporation for the stock, or as paid-in capital. As a long-term capital gain, the amount reportable by an individual is 50% of the total gain. In addition, this 50% of the gain cannot be taxed at a rate higher than 50%; all of which adds up to a maximum tax of 25% on the long-term capital gain.

All of the assets of the corporation must be valued at the fair market value as of the date of distribution. The values will in most cases differ from the figures shown on the balance sheet of the corporation. Where the market value of the asset is greater than the book value, the gain to be reported is correspondingly increased.

This can be turned into a substantial long-range tax benefit through a stepping up of the basis of the assets of the new, unincorporated business. The increase in value of the corporate assets is taxable to the stockholders usually as a long-term capital gain, and therefore subject to a maximum effective tax of 25%. On the other hand, the increased basis may be used by the new business to reduce ordinary income which is probably subject to a substantially higher tax rate.

Factor of Good Will

In connection with corporate dissolutions, note that the Treasury will try to find that the dissolved corporation had a considerable amount of good will. The result will be to increase the taxable gain to the stockholder with no tax benefit to the successor partnership. Thus, the presence of substantial good will can make the tax cost of dissolving a corporation prohibitive.

Life Insurance Proceeds May Become Taxable

There is another penalty which may have to be paid for dissolving a corporation. The proceeds of any life insurance policies transferred from the corporation may lose their tax-exempt status. Life insurance proceeds are generally tax-exempt. However, when the policies are transferred for a valuable consideration, such as in return for stock, the transferee becomes taxable on the excess of the proceeds over the basis of the policy. Thus, if policies covering nonstockholder-employees are distributed on the liquidation of the corporation, the proceeds subsequently received will not be fully tax-exempt. The amount taxable will be the proceeds minus the cash surrender value at date of dissolution and the premiums subsequently paid.

Where the policies cover an employee-stockholder, a different rule apparently applies. The Treasury has held that where a policy is transferred to the *insured,* the proceeds still retain their tax-exempt characteristics. On the basis of this decision, where the policy is on the sole stockholder, the distribution of the policy to the stockholder would seemingly not make the future proceeds taxable. If the policy were on the life of only one of a number of stockholders, the future proceeds would presumably be taxable only as to the share belonging to the *uninsured* partners.

A transfer of a policy from an unincorporated business to a corporation in a tax-free transfer does not result in

changing the tax-exempt nature of the insurance proceeds. Therefore, the incorporation of a business does not face the problem involved in a corporate dissolution.

Carry-Overs and Carry-Backs

The carry-over and carry-back provisions also deserve careful study before deciding to change from one to another form of doing business. This consideration may decidedly tip the scales against any change. Losses of both corporations and partnerships can be carried back or carried forward for two years. But where a corporation dissolves and then operates as a partnership, any losses incurred as a partnership *cannot* be used to obtain a refund of taxes paid by the former corporation. Furthermore, the right of a corporation to carry back any unused excess profits credit for 1946 will likewise be lost. The converse is equally true. A corporation formed out of a dissolved partnership cannot apply the corporate losses against the income of the partners for prior years. Of course, the unused losses can still be carried forward. But this involves a long-range speculation with too many unknowns. The one definite fact is that the losses carried forward will not be able to offset high-rate war taxes.

True, if the business continues to prosper, the change in business form will have no effect on carry-backs (except for a possible unused excess profits credit which may develop because earnings are less than credit), since there would be no carry-backs regardless of whether the business form is changed.

Family Partnership

Many corporations have, in the past, dissolved and operated as family partnerships because of the resulting substantial decrease in taxes. A partnership which includes a wife or child as partner is an attractive business form for tax purposes. The income is divided between at least two persons, with the result that the surtax on the entire income is considerably smaller. Also, each member of the family who receives the income would be entitled to the maximum standard deduction of $500, even though he had no actual deductions.

Precisely because family partnerships are so attractive and because of the widespread use made of this device, both the Treasury and the courts have viewed them suspiciously. At the present time the Tax Court, after changing its mind two or three times, has apparently decided that it will *not* recognize a family partnership formed by means of gift where the husband or father continues to operate the business as before with no assistance from the "partners". This entire problem of family partnerships has been appealed to the Supreme Court, and they will rule upon this issue at the current session. Taxpayers should wait for their verdict before forming this type of partnership.

Forms Other than Partnership or Corporation

A business organization other than a partnership (or single proprietorship) or corporation usually has some characteristics of each of these forms. The business form will be taxed as a corporation or a partnership depending upon which it most closely resembles. The main features of a corporation are:

1. Beneficial interest in the corporation transferable without affecting the continuity of the business.
2. Limitation of liability of owners.
3. Security from termination or interruption by the death of owners.
4. Centralization of management through representatives of the members of the corporation.
5. Holding of title to property as an entity.

Any type of organization which has these corporate characteristics will be taxed as a corporation regardless of the name given it by local law. An organization need not fall into the legal definition of a corporation in order to be taxed as a corporation, and the business

form need not be *identical* to a corporation to subject it to corporate taxes. The test is whether the business form *resembles* the corporate form. If an organization, planned as a partnership, is stretched to include too many of the corporate characteristics, it faces the danger of being taxed as a corporation.

Trusts

A trust created by will or by declaration of the grantor is taxable in the same manner as an estate, where the trustees take title to the property for the purpose of protecting and conserving the corpus. This means the trust is taxed only on income not distributed or distributable to the beneficiaries, and at the same rates applicable to individuals, except that an exemption of only $100 is allowed. It is taxed more like a partnership than a corporation. But this special method of taxing trusts does not apply to a trust organized to hold and manage property with the primary view of making a profit for the beneficiaries. Such a trust is considered a substitute for a corporation and is taxed as one. Thus, a trust which is created and maintained for the conduct of a business enterprise will normally be taxable as if it were a corporation.

A trust may sometimes be used to advantage in connection with the liquidation of property. For example, a trust created to dispose of particular property, with incidental powers granted to the trustees to manage the property until actual liquidation is feasible, is not taxable as a corporation. It is looked upon as a pure trust so long as the trustees do not carry on business activities which are not properly incidental to the liquidation.

Joint Venture, Pool, Group, Etc.

Any unincorporated organization of more than one person whether called a syndidate, group, pool, joint venture, etc., which does not come under the definition of a corporation, trust, or estate, is taxed as a partnership. The legal test is simple: If a business form does not have a close enough resemblance to a corporation to be taxed as a corporation it will be held to be a partnership.

Limited Partnerships

For tax purposes, limited partnerships are classified either as ordinary partnerships or as associations taxable as corporations, depending upon their character. If the organization is not interrupted by the death of a general partner or by a change in the ownership of his participating interest, and if the management of the organization's affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation. If it does not have these two characteristics, a limited partnership is treated as an ordinary partnership. The fact that a limited partnership is created under the laws of a state that has adopted the Uniform Limited Partnership Act does not determine the tax category. For example, although New York, Pennsylvania and Tennessee have all adopted the Uniform Partnership Act, limited partnerships are classified differently for tax purposes in each state—in Pennsylvania as associations taxable as corporations, in Tennessee as ordinary partnerships or associations according to the provisions of the certificate, there being no fixed rule, and in New York as ordinary partnerships.

Individual Proprietorship

Operating as an individual proprietorship generally has the same business and tax consequences as the operation of a partnership. All the observations regarding the advantages and disadvantages of a partnership apply with equal strength to an individual proprietorship.

Conclusion

The number of items which must be considered makes it difficult to arrive at a decision as to the form of business to be adopted. It is only after a thorough analysis of all the pertinent facts that such a decision can be reached.

Right Dress

By Thomas W. Byrnes, C.P.A.

THERE is a time and a place for everything. Memory pictures Aunt Sophronia and Uncle Asaph strolling on a Sunday afternoon in the early 1900's. She in a sedate tailor-made down-to-the-ground walking suit, and walrus-mustached he in a tall silk hat, frock coat, striped trousers, high button shoes, and Oh Yes, carrying a gold headed cane. Quite the mode in those days, but if they were to appear today what shrieks of raucous laughter that happy pair would evoke from the long-haired men and short-haired women one now sees in Sunday attire of open-neck sport shirts, slacks accentuating positive bulges in the wrong places, and sloppy foot-wear. In that earlier era business and professional persons, and their staffs dressed in keeping with the tenets of good taste while engaged in their daily tasks. If the changed attitudes toward leisure habiliments were confined to the hours of relaxation and places of comparative obscurity little fault would be found by nonconformists. However, the tendency of recent years has been to carry the informality of personal appearance into business, and one frequently finds office and other employees reporting for duty arrayed for hikes, the tennis court, and other types of recreation. That this spirit has been shared and the practice followed by young persons engaged in public accounting are the reasons for these lines.

Thomas W. Byrnes, C.P.A., has been a member of the Society since 1911, and is a certified public accountant of New York and New Jersey. He is an instructor in advanced accounting at Columbia University and also serves as lecturer and associate professor. Mr. Byrnes is a member of the American Institute of Accountants.

A profession imposes obligations upon its practitioners. The outward appearance of dignity is one of them, and to observe this and to command the respect of the community as a professional, one must first look the part. Just because time seems to have outmoded the special Sunday suit custom of years gone by is no justification for carrying a continuous holiday atmosphere into one's workaday activities. Carelessness on the part of assistants in the matter of dress, and failure to evidence other outward indications of acquaintance with the requirements of respectability, have caused embarrassment to many accounting firms.

This writer deplores the tendency towards untidiness and without presuming to suggest how the young accountant should present himself at his or the client's office, offers the following excellent advice taken from "Auditing Procedure" by Bacas, Madden, and Rosenkampf: "The public accountant should be neatly dressed He should avoid gaudy attire and sporty clothes. He should naturally be clean and keep his clothes in good condition. Those who have business with

a public accountant expect to deal with a person who is careful and conservative. If the appearance of the public accountant does not bring these qualities to mind, he is often at a disadvantage."

There is another worth-while side to the matter discussed above and it is the degree of assurance and self-confidence possessed by the person who knows that in any company his appearance is above reproach. To this feeling of self-esteem may be added what Dickens says in Martin Chuzzlewit "Any man may be in good spirits and good temper when he's well dressed."

Aspirants for recognition as professionals owe something also to their colleagues. It is hoped this article will remind those who are lax that their appearance is not in their own best interest or the interest of the profession.

PROFESSIONAL COMMENT

Nature and Purpose of the Income Statement

A Report of the Subcommittee on the Income Statement to the Committee on Accounting Procedure of the American Institute of Accountants

This report is intended to express only the views of the subcommittee and should not be interpreted as a statement by the committee on accounting procedure. Its presentation in this manner conforms to the intent of the committee to advise the profession of all questions that are under consideration by it and to request those who wish to do so to present their views before the content of a bulletin on this general subject is determined.

Communication should be directed to the Committee on Accounting Procedure of the American Institute of Accountants, 13 East 41st Street, New York City.

(1) The subcommittee on the income statement has considered the form of such statements generally and with particular reference to the treatment of items which by reason of their size or their lack of direct relationship to the operations of the year are in some classifications reflected in either a special section of the income statement or in the surplus account.

(2) Statistical material kindly made available by the Chief Accountant of the Securities and Exchange Commission and other data prepared by the Research Department of the Institute do not indicate that the investing public is being misled to any considerable extent by questionable treatments of such items.

(3) The subcommittee does not, therefore, regard the form of the income statement as a problem demanding immediate action to correct serious abuses, but rather as one calling for careful study with a view to making income statements more valuable for the various purposes for which they are used.

(4) In the past the problem has been considered mainly with regard to the danger of investors being misled through overstatement of income as a result of improper charges to surplus. The subcommittee believes that today understatement of net income is as likely as overstatement, and that any proposed solutions should be examined from both standpoints.

(5) The problem arises out of (a) the fact that in part allocations of items affecting the determination of income as between years are necessarily conventional and based on assumptions as to future events that are likely to be invalidated by experience (the items of which this is true, though usually few in relation to the total number of transactions, are frequently large in proportion to the amount of residual income); and (b) the disposition of even well-informed persons to attach undue importance to the net income shown for a particular year.

(6) The subcommittee believes that efforts should be directed toward the

following objectives: first, to educate the investing public to attach less importance to results of a single year and to consider, rather, the results of a series of years; second, to encourage the practice of drawing attention to items which have been excluded from the income for the period, whenever figures of net income or net income per share are presented to investors; third, to determine what general concept of net income for the year is most practically useful; and fourth, to define as clearly as possible conditions under which items might be excluded from the ordinary section of the income account and included in either a special section or in surplus.

(7) With a view to achieving the first of these objectives the subcommittee recommends that the Institute encourage the practice of showing, in annual reports, statements of income for a period of years, the earlier years being adjusted, where necessary, to reflect better information acquired subsequent to the original issuance of income statements for such years.

(8) In order to meet the second objective the subcommittee suggests (a) that it should be recognized as a requirement of good practice that where charges or credits are excluded from the computation of an amount described as "net income" and are either shown in a separate section of the income account or in surplus, the fact and the amount of such exclusions should be indicated in any reference to "net income" or "net income per share" in annual reports or press releases and the items should be described generally; (b) that an effort should be made to induce the financial press and investment services in such cases to indicate the amount and general nature of any such charges or credits not reflected in the figure reported as "net income" or "net income for the year." When it would be difficult to obtain this result by general explanations, a symbol might be used which would indicate the necessity of the investor referring to original sources to get a comprehensive report for the period. In this way the investor would have the benefit of the judgment of the management as to the amount properly to be regarded as net income for the year, and would also be advised of the existence of other items which he might wish to take into account in making his own decisions as to the amount of such net income.

(9) The subcommittee believes that while inclusion of items in a special section of the income account avoids some of the objections which can be urged against inclusion of such items in surplus, it does not dispose of all objections and creates new dangers. In general, the subcommittee believes that more items are likely to be excluded from the ordinary section of the income account if they are to be shown in the special section of that account than if they are to be treated as charges or credits to surplus. However, if the practices suggested in paragraphs 7 and 8 were adopted, this tendency would be counted for it is not likely that items would be reported in a special section unless the propriety of such treatment could be clearly sustained.

(10) If, as it would seem reasonable to expect, cooperation of the New York Stock Exchange as well as of the financial reporting services could be secured, this program could be made highly effective. Following the procedure already employed in relation to accounting for ordinary stock dividends, the Stock Exchange might draw the attention of all listed companies to the opinion expressed by the Institute and might intimate its intention of watching the development and taking such further steps, if any, as might be found desirable.

(11) The question of what constitutes the most practically useful concept of income for the year is

one on which there is much difference of opinion resulting in wide differences in practice. One of the concepts is that the net income for the year should be measured by deducting from the accumulated net income up to the end of the year the amount accumulated up to the beginning of the year. Another, and an entirely different concept, is one which emphasizes the relationship of items to the operations, and to the year, excluding from the income account any important items which are not so related.

(12) Two members of the subcommittee have undertaken to prepare a full memorandum on concepts of income with a view to its publication in such form as would seem to be desirable.

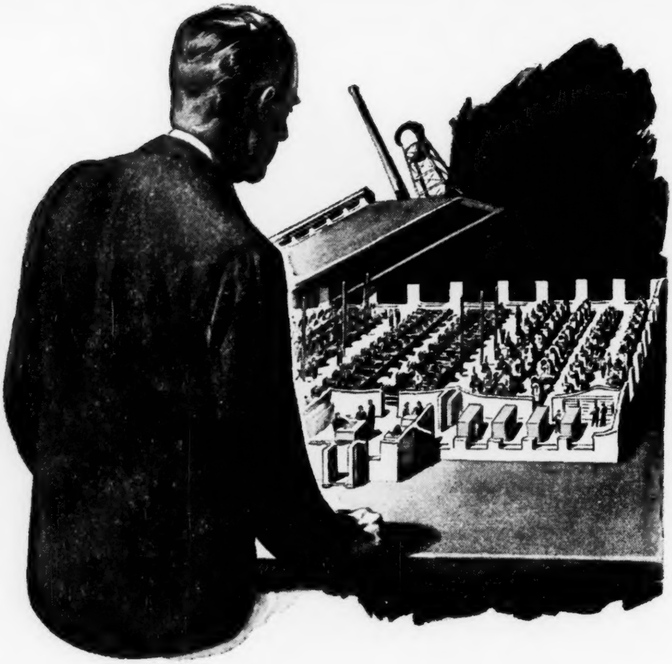
(13) The other three members of the subcommittee have undertaken to scrutinize the charges and credits to surplus or to special sections of the income account with a view to presenting criteria which will be helpful in determining what charges and credits may appropriately be subjected to this treatment.

CORRECTION

In the September issue of the New York Certified Public Accountant in connection with "What Did He Do When He Got There?" the author, Louis Gluick, was referred to as Lt. Commander instead of Commander.

In accordance with Navy regulations the following statement should have been appended to his article:

> "The opinions or assertions contained herein are the private ones of the writer and are not to be construed as official or reflecting the views of the Navy Department or the naval service at large."



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